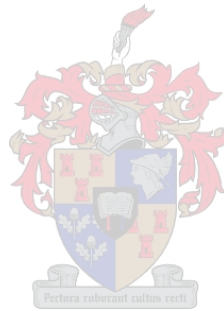


Reconsidering Distributions: A Critical Analysis of the Regulation of Distributions to Shareholders in the Companies Act of 2008, with Special Reference to the Solvency and Liquidity Requirement

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Declaration

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Summary

The Companies Act 71 of 2008 introduces a completely new system for the regulation of distributions by a company to its shareholders. The preferred method for protecting the interests of creditors in distributions is now based on a solvency and liquidity test. Regrettably, the provisions setting out the requirements for distributions on the one hand and the solvency and liquidity test on the other have been poorly drafted. This thesis first explains and then applies an innovative interpretation theory to these provisions with a view to piecing together coherent content. The thesis finds that creative interpretations will not suffice in various places, meaning that substantive revision is required. The thesis concludes with brief amendment proposals and accompanying commentary.

Opsomming

Die Maatskappywet 71 van 2008 bied 'n radikaal nuwe sisteem vir die regulering van uitkerings van 'n maatskappy aan sy aandeelhouders. Die voorkeur metode om die belange van skuldeisers in uitkerings te beskerm, is nou op 'n solvensie- en likwiditeittoets gebaseer. Ongelukkig is die wetlike bepalinge wat die vereistes vir uitkerings aan die een kant uiteensit, en die solvensie en likwiditeit toets aan die ander kant, swak opgestel. Hierdie tesis verduidelik eerstens die bepalinge, en pas dan 'n innoverende interpretasie teorie op hierdie bepalinge toe, met die doel om 'n samehangende inhoud daar te stel. Die tesis bevind dat kreatiewe interpretasies op verskeie plekke nie voldoende sal wees nie. Dit beteken dat substantiewe hersiening noodsaaklik is. Ten slotte bied die tesis kortliks wysigings-voorstelle met meegaande kommentaar.

Acknowledgment

This thesis is for my parents, for their deep and continued love and support. I also dedicate it to my girlfriend, who had to endure some trying months as I laboured to make the thesis work.

I am very grateful to Prof Sutherland for his incisive comments and excellent supervision, and for ceaselessly challenging me. Anything lacklustre in this thesis is my own doing.

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Chapter 1

Introduction

1.1 Introductory: Aim and Outline

This thesis considers the regulation of distributions to shareholders, particularly from the perspective of creditor protection. An undisputed premise – the main reason behind the genesis of the thesis – is that many of the distribution provisions (not to mention, very much of the rest) of the recently adopted Companies Act 71 of 2008 (‘the 2008 Act’) are conceptually anomalous and occasionally even incoherent.¹ Besides substandard drafting, it is also clear that the 2008 Act strikingly lacks a systematic and clear conceptual structure, as well as a unified and coherent policy perspective. Not only is a focused philosophical vision not readily discernible upon a reading of the Act, but further, “...neither the policy document nor the explanatory memorandum articulate in any detail the considerations that informed the proposals regarding...distributions”.² This makes for a highly undesirable state of affairs: on the one hand foggy provisions abound, on the other interpretative guidance is missing.

The task of the scholar evidently increases in importance: legal uncertainty looms large, and those who are forced to apply these provisions will desperately require assistance. It is essential to attempt to piece together the muddled or incongruent provisions in a workable form. But the larger, more fundamental object is to begin to discern a deeper foundational logic; I aim to sketch the outlines of a practicable and efficient analytic framework or conceptual structure, in the sphere of distributions to shareholders (but also more broadly in corporate regulation, especially as it informs distributions).

¹ In my view, in the literature in general this point has not been adequately stressed. A recent article by PJ Sutherland proves a noteworthy exception, see “The state of company law in South Africa” 2012 *Stell Law Review* 157. Many of the ideas put forth in this work were prompted by the critical spirit of the author’s arguments. Nevertheless, most prominent corporate law scholars in the country do point out weaknesses and suggest improvements. See, for instance, Jooste “The maintenance of capital and the Companies Bill 2007” (2007) 124 *SALJ* 715; Jooste “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” (2009) 126 *SALJ* 627; Van der Linde “The regulation of distributions to shareholders in the Companies Act 2008” (2009) 3 *TSAR* 484; Van der Linde “The solvency and liquidity approach in the Companies Act 2008” (2009) 2 *TSAR* 224; Van der Linde “The regulation of share capital and shareholder contributions in the Companies Bill 2008” (2009) 1 *TSAR* 39. Furthermore, regarding case law, for instance, in *DH Brothers Industries (Pty) Ltd v Gribnitz NO and Others* (3878/2013) [2013] ZAKZPHC 56; 2014 (1) SA 103 (KZP); [2014] 1 All SA 173 (KZP) paragraph 18 the court registers a conceptual anomaly concerning the business rescue provisions.

² Van der Linde “Distributions to shareholders” (2009) *TSAR* 492.

The above mentioned problem necessitates two further explorations. A philosophical and legal investigation into the very nature of interpretation is required. Interpreting (applying) the (distribution) provisions of the 2008 Act *as is* – descriptively, factually – will often be inefficient or illogical (at best) and completely unworkable or unfair (at worst).³ Naturally, *normative* interpretative inventiveness or creativity seems necessary: but what legal (authoritative) bases exist by virtue of which such liberties may be taken? I intend to utilise normative interpretation with a view both to making the law cohere as well as to streamlining it. Without question, I will have to justify this approach.⁴ The other consequence is that (not only a critical but also) a comparative perspective is required. Not only is it invariably instructive to glance at the manner in which other systems deal with similar problems (the agency problems and efficiency considerations at play do not differ much across different jurisdictions)⁵ but more urgently: it is also often the case that South African law has borrowed from another system in the first place, in which case the suitability, efficiency and overall coherence (also within the larger scheme of corporate regulation) of the borrowed provision(s) requires investigation or justification.

The thesis has two broad aims, one being interpretative, the other regulative (legislative). First, I hope to elucidate a coherent, efficient and practicable interpretation of the current (often lacklustre) distribution provisions. Second, where the latter will prove inadequate, substantive regulative proposals for reform will be suggested.⁶

It will be necessary to gauge exactly what the legislature *actually* enacted and to juxtapose this with its *purported* objects. The results can in turn be measured against a broad analytical framework representing modern trends and economically realistic perspectives in corporate law. In this way an efficient and logical conceptual foundation emerges on the basis of which deficient or lacklustre provisions can be reformed or streamlined.

The research aim will thus broadly be to consider the distribution provisions of the 2008 Act against the background of both the legislature's own perceived policy objectives and a sound

³ Such instances will emerge below in an analysis of the relevant provisions.

⁴ A separate chapter is thus devoted to a jurisprudential analysis of interpretation (see chapter 2). In order to place my proposed analytical framework (and subsequent analysis of relevant provisions) on a firm logical basis, this chapter is entirely indispensable.

⁵ H Hansmann & R Kraakman "What is corporate law?" in R Kraakman, P Davies, H Hasmann, G Hertig, K Hopt, H Kanda & E Rock *The Anatomy of Corporate Law: A comparative and functional approach* (2004) 1 1.

⁶ See chapter 6 below.

conceptual structure for distributions. The outlines of the latter can also be discerned from a comparative analysis. Moreover, I will need (briefly) to consider the aims of corporate regulation and the theoretical nature of the company, since my concern is chiefly with conceptual structure or philosophical justification and, ultimately, utilising that structure to advance useful reform proposals.

A pervasive and fundamental inquiry concerns that of creditor protection: whether or not it is desirable/necessary and if so, which legal mechanisms are to be employed to this end? Accordingly, the solvency and liquidity requirement – the major requirement for a lawful distribution under the 2008 Act, aiming to safeguard the interests of creditors – is carefully analyzed; untangling the concept of solvency and liquidity perhaps comprises the pervasive pulse of the thesis. A short survey of the precursor to the solvency and liquidity approach, namely the capital maintenance doctrine is first apposite. This will form part of some necessary background remarks.

1.2 Background

1.2.1 The Capital Maintenance Doctrine

It is trite that the affording of limited liability to companies poses unique risks for corporate creditors. Consequently, corporate regulation virtually everywhere, *inter alia*, endeavours to shield creditors against the risk of shareholder opportunism, that is, the risk that shareholders will simply withdraw company funds to the detriment of corporate creditors.⁷ The traditional principle seeing to this is the capital maintenance rule.⁸

In short, the doctrine entails that the issued share capital of a company must be maintained – cannot be returned to shareholders – so as to serve as a guarantee or trust fund acting as security for corporate creditors.⁹ Most pertinently, as a result, dividends may not be paid out

⁷ The normative question whether creditors *should* be protected by corporate regulation and (if they should) the degree of protection is a matter of scholarly debate; I tersely tackle the matter in the next section.

⁸ It is not within the scope of this thesis to expound this principle in any great detail. On the development of the principle, see Brincker *Geldelike Bystand* 29 – 44.

⁹ Cassim “The reform of company law and the capital maintenance concept” (2005) 122 *SALJ* 285.

of share capital.¹⁰ Hence, the reward to a shareholder for his investment in the company (dividends) could only be paid out of profits.¹¹ A company was traditionally, moreover, legally unable to repurchase its own shares – consisting, of course, in a return of share capital.¹² Having initially been adopted in South Africa via the common law, these principles were later statutorily qualified. Packaged as a financial limitation on distributions, the capital maintenance rule outlaws distributions to shareholders save “...out of an excess of the company’s assets over the sum of its liabilities plus share capital”.¹³

The theoretical justifications for the doctrine are various; they do not seem to have developed particularly sequentially or logically. The following have been advanced: the doctrine’s imposition is tantamount to the price shareholders are obliged to pay in exchange for the benefit of limited liability; that it gives effect to an implied contract between the company and the creditors; and that the share capital constitutes a guarantee or trust fund safeguarding the interests of creditors.¹⁴ By reference to McGee,¹⁵ Van der Linde summarises “a set of rational objectives” discernible in the doctrine:¹⁶

- Protecting existing shareholders from the forced depletion of their interest in the company and by dilution of that interest by its devaluation
- Protecting the company as entity from being looted by unscrupulous shareholders or promoters
- Protecting creditors from unjustified dilution of the value of the company.

Be that as it may, the principal concern remains that of protecting creditors. And the need for this protection springs from affording shareholders limited liability.

In Europe and in America, the term ‘legal capital’ is frequently used, and its relation to the concept ‘capital maintenance’ is not always clear. Van der Linde notes that ‘legal capital’ is “potentially wider...because it also encompasses the specific share capital structure on which

¹⁰ This principle, amongst others, was evinced in England by the judiciary near the end of the nineteenth century; see *Guinness v Land Corporation of Ireland* (1883) 22 ChD 349 CA (356); *Re Exchange Banking Co, Flitcroft’s Case* (1882) 21 ChD 591. It was inferred from legislation in force at the time (The Companies Act of 1862 (25 & 26 Vict c 89)), as well as the ultra vires rule.

¹¹ Really, the common-law rule stating that dividends cannot be paid out of share capital was supplemented by a rule stipulating dividends may be paid only out of profits. See Gower and Davies’ *Company Law* 7 ed 275.

¹² The question of share repurchases or ‘buy-backs’ cannot be dealt with in great detail. Additionally, I will not discuss the vexed question of par value shares – shares traditionally could not be issued at a discount below their par value – and the issue is no longer especially important with the elimination of the possibility of authorising new par value shares.

¹³ Van der Linde *Aspects of the regulation of share capital and distributions to shareholders* LLD dissertation UNISA (2008) 21.

¹⁴ 20 – 21. See also Manning *Legal Capital* 50 – 53.

¹⁵ McGee *Share Capital* 139.

¹⁶ Van der Linde *Aspects* 21.

a particular contribution and distribution regime is based”.¹⁷ That is, the concept ordinarily refers to that body of rules regulating shareholder pay-in obligations and distributions (pay-out obligations), as well as *share capital structure*.¹⁸

The capital maintenance doctrine has fallen out of favour in the last quarter of the twentieth century and was abolished in numerous countries. Initially the doctrine was recognized as South African law and the idea that the paid-up share capital of a company serves as a trust or ‘guarantee fund’ protecting creditor interests was confirmed by our highest court at the time.¹⁹ In 1999 a sea change was set in motion and South Africa followed the increasingly common trend of moving away from capital maintenance. The break was, unfortunately, not a clean one. Van der Linde explains that

the Companies Amendment Act 37 of 1999 introduced amendments which ‘changed dramatically the capital maintenance rule and the perceived protection it afforded [creditors]. Although these amendments brought about significant changes in the regulation of distributions to shareholders, the provisions underpinning the concepts of authorised and issued capital and the capital maintenance principle were not amended. This has given rise to certain anomalies and the amendments have been described as ‘unsystematic efforts to eliminate the capital maintenance principle’.²⁰

Therefore a central concern of the company law reform process consisted in modifying share capital provisions. The trouble is – as I have noted earlier – neither the policy document (*South African Company Law for the 21st century – Guidelines for Corporate Reform*),²¹ nor the *Explanatory Memorandum to the Companies Bill 2008*²² (‘the explanatory memorandum’) properly spells out the factors underpinning the proposals concerning distributions and share capital.²³

Anomalous and irregular though it may be, South Africa’s shift away from capital maintenance and towards a solvency and liquidity approach has picked up momentum since 1999. So arguably lacklustre has the capital maintenance doctrine ostensibly been that even in

¹⁷ 23.

¹⁸ 22.

¹⁹ 252. See *Lewis v Oneanate (Pty) Ltd & Another* 1992 (4) SA 811 (A) at 818.

²⁰ Van der Linde *Aspects* 252.

²¹ GN 1183 in GG 26493 of 23 June 2004.

²² This appeared at the end of the Companies Bill 2008.

²³ Van der Linde *Aspects* 252 – 253.

Europe – “the current stronghold of capital maintenance”²⁴ – a reassessment is currently underway.²⁵

So why is capital maintenance increasingly discarded? There are several reasons. One is that the concept ‘capital’ was interpreted restrictively, so that it was permissible to pay dividends on profits made in a given year without consideration for losses in previous years.²⁶ Dividends could, furthermore, be paid out of unrealised gains in certain cases;²⁷ additionally, it was not required that unrealised losses in respect of fixed assets be considered. Another reason is that share capital is not immunised against business risks: restricting the return of capital to shareholders does not prevent assets representing capital from being exposed to business risks and so possible loss. At any rate, there was often little use in even talking of a capital ‘guarantee fund’: no minimum capital requirements were prescribed – companies were (are) significantly funded rather by loans – and so there is often little capital (and the resultant ‘cushioning effect’) to speak of. In short, the doctrine seemingly fails to succeed in its primary task: protecting creditors.

The issue of the size of share capital – it usually being negligible – is sometimes countered by the suggestion of prescribing specific ratios of debt to equity.²⁸ The problem, though, still hinges on the degree to which additional funds can become available for payment to creditors; capital is also often tied up in illiquid assets and hence unavailable for payment to creditors.²⁹ This is because companies are freely able to buy assets that decline in value, meaning companies can instantly start incurring losses, so that, practically speaking, their paid-in capital is a meaningless amount.³⁰ For this reason, it cannot really be said that creditors in fact place much reliance on a company’s share capital in deciding whether to grant credit to it or not. Credit risk being their real concern, creditors actually take into account factors like “balance-sheet gearing, interest cover...[,] minimal tangible net worth”;

²⁴ 24.

²⁵ The feasibility study regarding an alternative to capital maintenance commissioned by the EC embodies a helpful summary of the various proposals advanced by influential groups (e.g. SLIM Group; Lutter group; Rickford group and the like): KPMG *Feasibility Study on Capital Maintenance – Main Report* (Contract ETD/2006/IM/F2/71) 269 – 310. For further references, see Van der Linde *Aspects* 24 n 140.

²⁶ *In re National Bank of Wales Ltd* (1899) 2 Ch 629.

²⁷ *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] Ch 353.

²⁸ Van der Linde *Aspects* 25.

²⁹ See Enrique & Macey “Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules” (2001) 86 *Cornell Law Review* 1187.

³⁰ 1187.

they rather give significant weight, moreover, to “contractual restrictions and personal guarantees by directors or major shareholders”.³¹

A further (very thorny) difficulty concerns the often impenetrable task of discerning and managing the extent of the share capital.³² Not only has it been cogently argued that compliance with capital maintenance rules is difficult and costly, but their overall impact is to reduce equity investment.³³

In South Africa, the rules regarding capital maintenance derived in part from the common law and in part from legislation. The capital maintenance rules were far from clear because of this double source; uniformity, consistency and rational development were hardly traceable in the case law.

1.2.2 Agency problems, Creditor Protection and the Objects of Regulation

Transactions that lead to share capital flows out of a company, or transactions giving a return on share capital, hold noteworthy potential for conflict between stakeholders. The resultant conflicts are various: they exist between shareholders *inter se* – between majority (controlling) and minority shareholders – and between directors (managers) and shareholders; the most important conflict of interest – for the purposes of this thesis – is that between creditors and shareholders.³⁴ The primary risk consists in the power shareholders have to manipulate limited liability to the detriment of corporate creditors.

In the language of economics, these conflicts within the corporation give rise to ‘agency problems’. From this perspective – that is, the law and economics point of view – the object or function of corporate regulation ought to be both to lower the costs of business contracting, (or to create contracting efficiency) and to minimise value-reducing opportunism by stakeholders.³⁵ Whincop observes³⁶

³¹ Van der Linde *Aspects* 26.

³² 26.

³³ Enrique & Macey “Creditors Versus Capital Formation” (2001) 1186 – 1191, 1202, 1168.

³⁴ Hansmann & Kraakman “Agency problems and legal strategies” in R Kraakman, P Davies, H Hansmann, G Hertig, K Hopt, H Kanda & E Rock *The Anatomy of Corporate Law: A comparative and functional approach* (2004) 22.

³⁵ Hansmann & Kraakman “What is corporate law?” in *The Anatomy of Corporate Law: A comparative and functional approach* 2.

³⁶ Whincop *An economic and jurisprudential genealogy of corporate law* (2001) 172.

An appropriate objective for the law is to allocate the costs of fraudulent transactions in a way that minimises the contractor's and the corporation's (shareholders') joint costs of unauthorised transactions. [...] In effect, one would prefer to allocate the risk to the party with the lowest costs of avoiding the unauthorised transactions[.]...

Of course the mentioned agency problems are peculiarly impacted by a given constellation of corporate activity. It is essential constantly to be mindful of the idiosyncratic assemblages constituting the various corporate law regimes in the world: irreducibly unique political dispensations and trends, corporate incentives and structures, social permutations, divergences in wealth distribution (and the like) invariably shape (corporate) laws. In this regard the concept of path dependence carries some explanatory power.³⁷ Path dependence is concerned with unearthing the reasons behind divergences in business structures and practices which subsist between different countries in the face of otherwise similar corporate architectures. Differences in corporate ownership and governance – despite an ostensible global convergence in economies and business practices – remain and must be taken seriously. The idea of path dependence is just one way of tracing and predicting the shape future changes will take.

More fundamentally, influential corporate law scholars – especially of the law and economics breed – think it the purpose of corporate law to advance the aggregate social welfare (this in addition to self-evidently defining the various business enterprises and attempting to contain the agency problems between its stakeholders). So, by implication, the aggregate welfare of both principals and agents should be boosted. Hansmann and Kraakman shrewdly doubt whether the maximisation of shareholder value in general succeeds in advancing social welfare; fortunately, also, they admit that legal institutions sometimes privilege a particular corporate participant or group on the basis of politics or some other contingent consideration or trend – that is to say, it is conceded (though in my view understated) that legal regulation is not as a matter of course efficiency-oriented or economical.³⁸ Like many other advocates of a broadly economic flavour, they overestimate the level of rationality most institutions and actors approximate to. They assert that creditors – including employees and consumers – will only contract with a corporation in the event that they themselves anticipate being better off

³⁷ Bebchuk and Roe "A theory of path dependence in corporate ownership and governance." *Stanford Law Review* (1999), 127.

³⁸ 18 – 19. Perhaps the most famous statement on the utility- or necessity of profit maximisation is Milton Friedman's: "There is one and only one responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud." Milton Friedman, *The social responsibility of business is to increase its profits*, THE NEW YORK TIMES MAGAZINE, (September 13, 1970).

as a result.³⁹ Often, however, it will not be reasonably possible to predict this *ex ante* but, moreover, inequality of bargaining power will often rob smaller creditors of assumed contractual agency. Merely viewing the law as a mechanism commissioned to reduce overall transaction costs, often diverts attention from the formative influence of politics, and the inequality inherent in many contractual bargains.

In America, the point of departure often seems to be: why should the law protect creditors at any rate? Why can they not look after themselves?⁴⁰ Corporations are conceptualised as privatised, market-like institutions marked by individual autonomy, and free contractual regulation; they are anything but hierarchical, self-generating (coercive) power centres subject to public governance. To varying degrees, these assumptions can be conceptually traced back to a ‘corporation as nexus of contracts’ outlook.

Interestingly, Hansmann and Kraakman argue that the only essential function of corporate law is that it makes possible ‘affirmative asset partitioning’ – that is to say, all other fundamental elements of a company can be established and maintained through contractual means or private ordering.⁴¹ Now, simply put, affirmative asset partitioning basically entails that the creditors of the shareholders cannot enforce their claims against the company – the reverse of limited liability. This is the only basic attribute of a company that, in their words, “...could not feasibly be established by contractual means alone”.⁴²

Essentially, then, all the other characteristic elements of the corporation, on their reasoning, can realistically (“feasibly”) be contractually designed. Their contention is unconvincing. The core aspects defining corporate structure – perpetual succession, directorial fiduciary duties, the separate liability of the company, centralised management, transferable shares, and the like – are not trivially or accidentally laid down by statute. Decidedly mandatory and involuntary tools are invoked for a reason: shareholders rarely agree individually to corporate decisions, and individual contractants can scarcely agree to render a third party liable for their actions. Conceptually, therefore, numerous corporate schemes are at odds with foundational

³⁹ Hansmann & Kraakman “What is corporate law?” in *The Anatomy of Corporate Law: A comparative and functional approach* 18.

⁴⁰ To be fair, in reality a view (along these lines) espoused by an advocate of this approach will naturally be nuanced. It will often be the case that statutory creditor protection will benefit both creditors and shareholders, i.e. where the costs of raising debt capital through the corporate structure are diminished. A thoughtful proposal will recognise that the aim cannot simply be to do away with opportunism; rather the object must be to attempt to actualise a proportionality (of sorts) between the costs of opportunism and the costs of minimising opportunism; see Hertig & Kanda “Creditor Protection” in *The anatomy of corporate law* 71.

⁴¹ Hansmann & Kraakman “The Essential Role of Organizational Law” (2000) *Yale Law Journal* 110 390.

⁴² 393.

contractual norms; practically, the contractual administration and enforcement of such schemes does not seem feasible. In all likelihood, even on efficiency grounds, a pure nexus of contracts (however engineered) – in the stead of the corporate form – is not workable.⁴³

Perhaps the conceptual basis of a roughly US-style view advocating no or little statutory protection to creditors is not tenable. So, not only are weaker or smaller creditors vulnerable to exploitation in the contractual process under such a model – in addition to the foregoing concerns I have noted – but there is also the problem of involuntary creditors. Such creditors cannot conclude contracts with the company to safeguard their interests – e.g. delictual creditors; their debts were not voluntarily (contractually) incurred.⁴⁴ The justification of corporate regulation – especially aiming to protect creditor interests – arguably follows naturally from the very fact that the law created the corporation to begin with. This roughly appears to represent the English approach: limited liability is conferred on a company by the state; it thus stands to reason that the state should regulate corporate structure and activity in the interests of creditors and the investing public. The European Union mirrors this approach. The point of departure or initial premise being that creditors (and shareholders) require legislative protection as a necessary foundation of any corporate law system.⁴⁵ This profound philosophical divergence – between Europe and America – is quite prominent in regard to the issue of creditor protection.⁴⁶

Aside from the aforesaid well-documented divergence, creditor protection across most systems largely corresponds. The principal concern of creditors also remains the same in every jurisdiction: that their claims are satisfied when they become due. Creditors are usually protected particularly when a company nears insolvency: for instance, directorial liability can be imposed for insolvent trading, as well as the imposition of fiduciary duties on directors relative to creditors. Such matters will not receive direct attention in this thesis. Rather, my concern is with creditor protection as regards limitations on the distribution of corporate funds. (Although it is important to bear in mind that this part of the law should also be construed in view of other rules aiming to safeguard the interests of creditors.)

⁴³ I am referring to the notion of contract as it is legally understood; particularly nuanced economic notions of contract may indeed escape my criticisms.

⁴⁴ Hansmann & Kraakman “Toward unlimited shareholder liability” (1991) 100 *Yale Law Journal* 1879 on this point argue for an exception to limited liability regarding damages to be paid to delictual creditors. For a contrary view, see Goddard “Corporate Personality – Limited Recourse and its Limits” in R Grantham & C Rickett *Corporate Personality in the 20th Century* (1998) 11.

⁴⁵ Cassim “The reform of company law” (2005) 122 *SALJ* 285.

⁴⁶ Enrique & Macey “Creditors Versus Capital Formation” (2001) 1166.

Since one of the chief conflicts of interest involves shareholders in relation to creditors, a brief remark is now apposite on the nature of their respective rights vis-à-vis the company, as well as the legal difference between these two stakeholders. Any corporate law regime has to attempt to balance the legitimate interest shareholders have in a return on their investment, with the primary interest of corporate creditors: that the board will not drain the company of assets through dividends (share repurchases or otherwise) – particularly when the board realises the company is in financial trouble – unduly leaving them insufficient assets.⁴⁷ Now the legal difference between creditors and shareholders are well known. Shareholders invest in a company by purchasing shares in it. In exchange for contributing to the share capital of the company, the shareholder acquires certain rights (constituting the share(s)). It does not follow that the shareholder has a legal right to the return of the contributed capital. The company – existing independently of its participants in the eyes of the law – owns its assets – including the contributed capital – and is itself liable for its debts. Limited liability dictates that shareholder assets are shielded against company creditors. Creditors of the company have claims which rank higher than the (personal) creditors of the shareholders to the company funds. Personal creditors of the shareholders, furthermore, cannot claim the shareholder's interest in the company assets. And (as illustrated earlier) a shareholder cannot simply withdraw her stake if she so chooses.

Van der Linde states that there is a qualitative – not a quantitative – distinction between the investments of shareholders and creditors.⁴⁸ She says company law requires a residual beneficiary: at least one issued share must have the unlimited potential to receive profits as well as assets upon liquidation.⁴⁹ Share capital is often said to be the price for limited liability: but, Van der Linde opines, it is also the price for unlimited entitlement.⁵⁰ So the potential gains shareholders stand to make – as residual claimants – are not contingent upon the size of the share capital ventured but rather on the profitability of the business as a whole, and are as such unlimited.⁵¹ Shareholders “...have an expectation, but not a right, to share in

⁴⁷ Hanks “The new legal capital regime in South Africa” (2010) *AJ* 132.

⁴⁸ Van der Linde *Aspects* 10.

⁴⁹ 10.

⁵⁰ 10.

⁵¹ 10. Normatively, this point is perhaps specious; see Greenwood “Dividend Puzzle” (2006-7) 32 *Journal of Corporation Law* 155.

the profits of the company during its existence and in any surplus assets upon its dissolution”.⁵²

Furthermore, it is the shareholder who often receives the label of ‘owner’ of the corporation. This is because the shareholder has the right to control the company – i.e. participation in voting to approve significant transactions and in the election of directors – in addition to the right to receive the company’s net earnings or profits.⁵³ Both of these rights, however, are normally proportional to the amount of the capital contributions by the shareholders.⁵⁴

Interestingly, Van der Linde also (perhaps principally) distinguishes creditors and shareholders on the basis that the latter has a *proprietary* right – the shareholder gives consideration and gets property in return in the form of shares – whereas the former merely has a personal right vis-à-vis the company.⁵⁵ But this is arguably an unfortunate and conceptually confusing distinction to draw. The shareholder’s right is only ‘proprietary’ (as Van der Linde has it) in a trivial sense: the right consists in the mere ownership of the share. But that property relation between shareholder and share – that ownership – is secondary to the more pertinent *personal* relationship: between shareholder and company. That is to say, essentially we are not concerned here with a real or property right but rather with the personal right of the shareholder against the company. And that right happens to consist in a share (in property): but a share *is merely a bundle of personal rights*. And so never is the supposed ‘proprietary’ nature of the shareholder’s right of any great import. Both the shareholder *and* the creditor have personal rights against the company – it is just that the precise source for each class of claimant will differ.⁵⁶ A personal right – which arises from an obligation – asserts a relationship between persons – that is, here, the stakeholder as against the company (a juristic person).⁵⁷ A personal right is available, not against persons generally but, against a specific person or persons.⁵⁸ Unlike real rights which belong to the law of property, personal

⁵² Van der Linde *Aspects* 9.

⁵³ H Hansmann & R Kraakman “What is corporate law?” in *The Anatomy of Corporate Law: A comparative and functional approach* 13.

⁵⁴ 13.

⁵⁵ Van der Linde *Aspects* 9.

⁵⁶ For instance, share versus credit granting agreement (contract).

⁵⁷ Whereas a real right asserts a relationship between a person and a thing; see Nicholas *An introduction to Roman law* (1962) 100. See also, for example, *Flexi Holiday Club v La Lucia Sands Shareblock Ltd* (2006) 2 All SA 479 (D) paragraph 13 in which the relationship between the shareholder and the company is described: “the shareholder enjoys a personal right against the company to share in its profits by receiving dividends and perhaps on liquidation to share in its eventual assets if any.”

⁵⁸ Except, of course, in the sense that the shareholder has a trivial property relationship with regard to the obligation itself.

rights fall under the law of obligations.⁵⁹ Barry Nicholas's ingenious statement best captured the crucial difference between real and personal rights as "...the difference between owning and being owed something".⁶⁰ Never, of course, can it be said that either a creditor or a shareholder legitimately *owns* the company assets (on pain of jettisoning the foundational principle of separate juristic personality). When the shareholder is branded the 'owner' of the company, this cannot mean, therefore, that she has a real right to the company: something looser in the way of 'having certain voting rights and being a residual claimant' is meant.

This analysis gives credence to the line in general taken by economic theory, in which shareholders are treated as a subspecies of creditors – that is, a type of creditor situated in the lowest rank in the hierarchy of creditors but who then have a residual interest in its assets.

Their position as investors is explained with reference to the same considerations that influence the conditions upon which credit is extended to the company, namely the duration of the investment, the expected return on investment, the risk involved and the degree of control that can be exercised over the company.⁶¹

In this way, then, it is often useful to conceptualise shareholders as a subspecies of creditors. This construction, moreover, prevents a conceptual confusion which views shareholders as true owners of the company. The label of creditor – as applied to shareholder – then serves the useful purpose of inferring a personal right and makes it clear that a shareholder does not have an ownership right. This construction situates the legal relationships of stakeholders (i.e. corporate creditors and shareholders) to the company squarely under the law of obligations – where, in my view, it belongs. The important caveat, mentioned earlier, must, however, be stressed: shareholders "...have an expectation, but not a right, to share in the profits of the company during its existence and in any surplus assets upon its dissolution"; shareholders occupy the lowest level in the pecking order of creditors.⁶²

⁵⁹ 101.

⁶⁰ 99.

⁶¹ Van der Linde *Aspects* 8.

⁶² This is not to suggest that ordinary creditors are to be equated with shareholders. In the context of decision (control) rights, for instance, – concerning the question of the decision-making process in the event that unforeseen eventualities come to light – it can be seen that shareholders possess decision rights to the extent that the company is solvent, whereas creditors acquire decision rights in default situations (see Hart "Financial contracting" (2001) *Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series*. Paper 327, 11.

1.2.3. A Short Survey of Distributions⁶³

The domain of distributions to shareholders has traditionally been one amenable to corporate regulation by statute.⁶⁴ The chief reason for that, as is apparent from the foregoing, resides in the need for safeguarding the interests of creditors: public policy requires that an appropriate balance be struck between the primary concern of shareholders to receive a return on their investment and the principal concern of creditors that company assets not be drained leaving insufficient funds for the satisfaction of their claims. Naturally, the legislature has to balance the interests of the various stakeholders in the company; over and above the protection of creditors, different classes of shareholders amongst themselves also require protection.⁶⁵ A distribution – in the sense in which I will use the term – consists in nearly any transaction of a company with its own shareholders which has the effect of reducing the shareholders' equity. In the normal case a company makes distributions to shareholders in the form of dividends or purchases of its own shares. (My main focus lies with the first form.)

A 'distribution' encompasses returns *on* share capital and the return *of* share capital.⁶⁶ Since capital need not any longer be maintained (in the traditional sense), share capital can be returned to shareholders, provided the relevant requirements and financial restrictions are satisfied. Of course, any anticipated return on the contributed capital is uncertain; even preference shareholders may get nothing if a dividend is not declared.⁶⁷ A shareholder only has an expectation – not a right – to receive dividends: but – in contrast to her *remote* expectation to share in the surplus assets at liquidation – this expectation is *vivid*.⁶⁸ Much has already been said – and much more will still be said – about the agency problems manifesting between creditors and shareholders. Just a word, then, on the issue of distributions to shareholders which frustrate the rights and interests of shareholders. Van der Linde highlights

⁶³ I only wish here to elucidate the bare bones of the law regarding distributions, i.e. the basic elements, structure, and distinctions. The critical analysis of its coherence and efficiency is found in later chapters.

⁶⁴ Eisenberg "The modernization of corporate law: an essay for Bill Cary" (1983) 37 *University of Miami Law Review* 187.

⁶⁵ McGough "Statutory limits on a corporation's right to make distributions to shareholders: the law of distribution in the 1984 Revised Model Business Corporation Act" (1987-1988) 21 *Akron L Rev* 29.

⁶⁶ Van der Linde *Aspects* 14. Van der Linde does not explain this statement; but its motivation is obvious enough.

⁶⁷ Ferran *Company law and Corporate Finance* (1999) 53.

⁶⁸ Van der Linde *Aspects* 14.

the most glaring difficulties, noting that such conflicts crop up even in the event that a company has only one class of shares where dividends are proportionate:⁶⁹

Dividends may be withheld to squeeze out minority shareholders or excessive dividends may be paid to deprive the company of investment opportunities. Similarly, selective distributions to some shareholders of a class are problematic, as they divert corporate assets to controlling shareholders at the expense of minority shareholders. They infringe the basic principle that each share in a class represents a homogenous claim on the wealth of the company. According to this principle, shareholders in a class are entitled to formal as well as substantive equality.

Perhaps one of the more striking conceptual or structural points regarding the new law on distributions is that the 2008 Act does not regulate the various types of distribution separately.⁷⁰ That is to say, the law is organised or structured around a solitary concept of ‘distribution’ – there is a single law of distribution, as it were. So, distributions, in general, are regulated under section 46 of the 2008 Act. Hence, the 2008 Act applies the same financial limitations to all distributions. It further does not prescribe the effect of distributions on the share capital accounts of a company. Basically, section 46 sets out the requirements for the making of a distribution. Notably, however, section 48 deals in particular with buy-backs, or more accurately: a company’s acquiring its own shares, and a subsidiary company acquiring shares in its holding company.

Section 1 of the Act contains a definition of ‘distribution’: this also covers a transfer of the consideration for the acquisition by a company of its own shares or shares in any company in its ‘group’. Consequently, where a company acquires its own shares or shares in its holding company, both sections 46 and 48 must be complied with. The other pertinent section which will be scrutinised later is section 77, which deals with directorial liability.

All distributions governed by the 2008 Act are encompassed in the definition of ‘distribution’ enshrined in section 1. A distribution divides into three possible sub-types:

⁶⁹ 15. Where more than one class of shareholder exists, the creation of preference shares throws up unique challenges. The issue of share repurchases looms large here: selective distributions to shareholders of a certain class normally take the form of a so-called ‘buy-back’. Share repurchases are not considered at length.

⁷⁰ The position under the Companies Act 61 of 1973 (‘the 1973 Act’) was dealt with under section 90, which tackled the issue by reference to a confusing expression ‘payments’. This concept included the distribution of profits and capital funds made without a reduction of share capital – hence the use of this term (as opposed to ‘distribution’); see Blackman, Jooste, Everingham, Larkin, Rademeyer & Yeats *Commentary of the Companies Act* (2003) 5 – 135. The 1973 Act did not prescribe an inclusive definition of ‘distribution’. Further, because there was later a superimposition of a solvency and liquidity outlook on a legislative scheme designed along the line of a capital maintenance outlook, the regulation of distributions under the 1973 Act was intricately confusing and fragmentary (see Van der Linde “The regulation of distributions” (2009) *TSAR* 484). The 2008 Act drastically transforms the law on distributions and I will not have occasion to dwell on the approach of the 1973 Act.

- A transfer of money or other property⁷¹
- The incurrance of an obligation⁷²
- The forgiveness or waiver of an obligation.⁷³

Each of these constitutes a distribution irrespective of whether it is achieved directly or indirectly.⁷⁴ It is the last-mentioned one which is perhaps most controversial and novel. Liquidation distributions are explicitly excluded⁷⁵ because surplus assets are only distributed to shareholders once corporate debts have been settled, meaning creditor protection is not necessary.⁷⁶

The memorandum must spell out the rights and preferences of each class of shares as regards distributions *generally*. That is, it is not exclusively required in regard to dividends.⁷⁷ Furthermore, all the shares in a class have to be treated equally. The memorandum can also entitle shareholders to ‘distributions’ calculated in specific ways.⁷⁸ Naturally, the memorandum may further cater for distribution preferences, as well as liquidation rights relative to different classes of shares.⁷⁹

The first type of distribution constitutes a direct or indirect transfer by a company of money or other company property (other than its own shares) to or for the benefit of one or more of its shareholders or the shareholders of another company within the same group. This can take the following forms (constituting an exhaustive list of distributions that can be made by way of a transfer of money or property):⁸⁰

- Dividends
- Payments in lieu of capitalisation shares
- Consideration for the acquisition by a company of its own shares
- Consideration for the acquisition by any company in a group of shares of another company in the group

⁷¹ Section 1 under ‘distribution’ paragraph (a).

⁷² Section 1 under ‘distribution’ paragraph (b).

⁷³ Section 1 under ‘distribution’ paragraph (c).

⁷⁴ See the introductory words of the definition in section 1.

⁷⁵ See the concluding words of the definition in section 1.

⁷⁶ Van der Linde “The regulation of distributions” (2009) *TSAR* 486.

⁷⁷ See sections 36(1)(b)(ii), 37(2)(b), and 37(4).

⁷⁸ Section 37(4)(c).

⁷⁹ Section 37(4)(d).

⁸⁰ R Jooste “Corporate Finance” in FHI Cassim, MF Cassim, R Cassim, R Jooste, J Sheve and J Yeats (eds) *Contemporary Company Law* (2011) 243; Van der Linde “The regulation of distributions” (2009) *TSAR* 486.

- Other transfers by a company in respect of any of the shares of that company or of another company within the same group.

There is no definition of ‘dividend’. Traditionally construed, one can attribute the following meaning: ‘a proportionate payment to a class of shareholders out of the *profits* of a corporation’.⁸¹ Because of the move away from capital maintenance, the rationale for distinguishing dividends and the residual class of other transfers as regards shares from a legal perspective is unclear: a definition which enables distinguishing proportionate and non-proportionate distributions with a concomitant difference in shareholder approval requirements would not make sense, since the 2008 Act focuses on approval of directors and not shareholders.⁸² In terms of the Act, it is accordingly immaterial whether a distribution falls to be classified under one of the particular mentioned instances.

The inclusion of payments in lieu of capitalisation shares as a distribution is fairly standard and uncontroversial. Since shares in the company are not deemed property which it transfers, the *issue* of capitalisation shares cannot be construed a distribution.⁸³

The transfer of money or property in consideration of the acquisition by a company of its own shares is the third instance of a distribution in the form of a transfer. A share repurchase requires compliance with both sections 46 (because it is a distribution) and 48 (the section setting out the requirements for buy-backs). No definition of ‘acquisition’ is supplied in the Act. Of course, strictly, a company is not able to acquire (or buy back) its shares since it cannot hold rights against itself.⁸⁴ Van der Linde notes that the concept must be taken to encompass any instance where a shareholder surrenders rights in respect of a share to the company, whether counter-performance is given or not.⁸⁵

Transfers as consideration for the acquisition by a company in a group of shares of another company in the group are very controversial. It is natural to regard a company acquiring shares in its holding company as a distribution. However, the idea of regarding as a distribution the acquisition of shares in a subsidiary or co-subsidiary is unwarranted. It seems

⁸¹ Van der Linde “The regulation of distributions” (2009) *TSAR* 487.

⁸² 487.

⁸³ 487. On this sub-type see section 47 of the 2008 Act.

⁸⁴ That is, a share is merely a bundle of (personal) rights and if the company acquires these rights, it stands to reason that it cannot sue itself for performance. In other words, the company is itself both the right- and the duty holder of a particular obligation.

⁸⁵ 488. This is why I said earlier that a distribution encompasses *almost any transaction between the company and its shareholders in terms of which shareholder equity is reduced*.

to conflict with the very nature of a distribution as a gratuitous return on- or of invested capital.⁸⁶ The other shareholders of the subsidiary – excepting the holding company – have not invested capital in the holding company: and in the event that they receive consideration for selling their shares to the holding company, the latter evidently receives value in return.⁸⁷

A transfer otherwise in respect of shares of the company or another company within the group constitutes a catch-all of sorts. This provision is nevertheless subject to section 164(19), which states that a payment in terms of appraisal rights will not constitute a distribution. It is not clear why only *this* provision is so limited. Nevertheless, the said exclusion will result, quite controversially, in shareholders who insist on being paid for their shares (because of their dissent with a particular corporate action) possibly receiving payment in competition with creditors.⁸⁸ Should a shareholder invoke the appraisal remedy, she need not even establish prejudice as a result of the intended corporate action.⁸⁹ So the 2008 Act gives such a shareholder creditor status, whereas payment due to a shareholder who succeeded in terms of the *oppression* remedy will be deemed a distribution, which is subject to the financial limitations, so that creditor status will not follow for the shareholder in such a case.⁹⁰ Both of these procedures aim to prevent shareholders from being locked into a company and so the disparate regulation is seemingly unwarranted. One would perhaps expect the conversion of shares into debt instruments to be *expressly* regulated, as the previous instances – to be a distribution (and so subject to the prescribed financial constraints) given that those creditors' interests might be affected in the case of a conversion.⁹¹ Van der Linde submits that such a conversion falls under this catch-all or residual category.⁹²

The second (sub-type) principal way in which a distribution can be effected is by a company incurring a debt or obligation for the benefit of its own shareholder or a shareholder of another company in the group. Two issues emerge here. One, what is the status of the incurrence of a non-monetary obligation: can abstaining from doing something or rendering a service be a distribution, and if so, how is it to be quantified?⁹³ Secondly, is it required that

⁸⁶ 491.

⁸⁷ 491.

⁸⁸ 489.

⁸⁹ 489.

⁹⁰ 489. See section 163(2)(g) of the 2008 Act.

⁹¹ 489.

⁹² 489. Although it is arguably more logical that it falls under paragraph (b) of the definition of “distribution” in section 1 of the 2008 Act (and hence not under paragraph (a)).

⁹³ 490.

the obligation be incurred *qua* shareholder (or by virtue of the shareholding of the shareholder)? No limitation to this effect is found in the statute; this wide scope might be unrealistic and unduly restrictive for the shareholders in a company. For instance, what is the position in case a shareholder becomes the beneficiary of a right against his company *qua* creditor and not in his capacity as shareholder? Surely this cannot be construed a distribution. Though this is unlikely to cause too much confusion, the definition could have been clearer.

The third main method by which to make a distribution – forgiveness or waiver by a company of a debt or other obligation owed to the company by a shareholder or a shareholder of a company within the group – suffers from the same capacity problem just discussed. Its inclusion might be useful in that it covers the waiver of a claim for outstanding performance on unpaid or partially unpaid shares.⁹⁴ Surely this provision cannot include waivers in respect of liabilities of other companies in the group, as this would be legally impossible.⁹⁵

Before providing an elaborate outline of my research hypothesis and questions, a last remark under this section is apposite. As I have been underscoring, creditor protection is essential where corporate distributions are made. It is important to note that the contrasting nature of the respective philosophies of the United States and the United Kingdom is most intensely felt when it comes to creditor protection. In short, a high premium attaches to statutory creditor protection in England (and the EU), whereas creditors are largely left to fend for themselves in America. Elements of each approach are discernible in the 2008 Act: this means that, because these two outlooks are uneasy bedfellows, corporate regulation is presently fragmentary, lacking a unified conceptual structure. The striking point is this: the 2008 Act on the whole, but specifically regarding distributions, probably due to the marked American influence, represents a controversial trend to afford the board of directors of a company significantly more power. Specifically relevant for the purposes of this thesis: it is now the *board* which must authorise a distribution.⁹⁶ The liability of directors in regard to distributions is addressed in sections 46(6), 77(e)(vi) – (vii), and 77(4) – (10). It is arguable that this demonstrable power afforded the board is commensurate with the extensive scope of liability assigned to them by these sections.

⁹⁴ 490.

⁹⁵ That is, it must be borne in mind that each company within the group is a separate legal person: a personal obligatory relationship exists solely between the shareholder and the company with whom she has entered into a legal relationship.

⁹⁶ Section 46(1)(a)(ii) of the 2008 Act.

1.3 Research Hypothesis

The hypothesis of this thesis is that the distribution provisions in the 2008 Act are in significant respects conceptually confusing and cannot be said to represent a unified, consistent philosophical vision. The resultant legislation – the 2008 Act – enacted by the legislature cannot even – linguistically, reasonably – be judged a fair reflection of its own perceived policy agenda.⁹⁷

1.4 Research Questions

The research hypothesis throws up numerous critical questions around which this study will be organised.

- (i) Did the legislature successfully create statutory provisions representing its purported aims? How do these laws and aims square with an economically realistic and philosophically sophisticated outlook on corporate regulation and distributions? What kind of underlying philosophy is discernible in the 2008 Act regarding distributions, and is it normatively justified?
- (ii) In case a distribution law's literal application would be impossible, inefficient, or otherwise undesirable, a measure of judicial (interpretative) creativity seems apposite (even necessary). How is this legally (authoritatively and linguistically) justified? And where should the limits to such acts of interpretative invention be?
- (iii) The central requirement for a lawful distribution is solvency and liquidity. The contours of these concepts are not yet clear, though their importance is unquestioned, as they embody the means by which creditors are statutorily

⁹⁷ Unearthing the reason(s) for this state of affairs is not easy and cannot really be considered in this thesis. Probably, it has a lot to do with the disparate range of influences in the drafting process: especially the tension between English- and US-style rules, as well as the concomitant divergence in underlying philosophy.

protected as regards corporate distributions (*inter alia*). Hence, it must be asked: what is the meaning of solvency and liquidity in the 2008 Act, and how should it be applied? I will address related questions such as: is this the best or most efficient way of protecting creditors? How does it relate to the capital maintenance principle? Is there a need both for a solvency and a liquidity element or will one suffice?

- (iv) In the light of the answers put forward to these questions – and having advanced a modest analytical framework for corporate regulation – I inquire into the coherence and efficiency of connected provisions. Are the provisions covering the authorisation of distributions, and the acknowledgment of solvency and liquidity coherent and efficient? To what extent is interpretative diagnosis sufficient to render coherent or streamline the confused parts and to what extent is substantive legislative reform required?
- (v) On the basis of the foregoing conclusions, as well as intermittent comparative analysis: what would conceptually coherent, economically refined, and philosophically sound distribution provisions look like? (That is to say: what form should an appropriate reform proposal take?)

1.5 Methodology and Overview

This study adopts a functional approach: an innovative interpretation theory is introduced and explained in order to provide a coherent reading of the law on distributions under the 2008 Act. I am always looking to make sense of the provisions of the 2008 Act as they stand through the lens of the interpretation theory I espouse in Chapter 2. I have not deemed it appropriate to undertake lengthy expositions of comparative law: no jurisdictions receive detailed and separate treatment, therefore. Piecemeal comparative analyses are only included insofar as they contribute to the exegesis of the law on distributions under the 2008 Act. The Model Act is probably referred to most, as it was itself an influence of the 2008 Act and it represents a good example of an efficient, self-contained system of (corporate) law. But on

the whole my functional approach requires a narrowing of the compass, focusing on the Act itself and interpreting it through the lens of my interpretation theory.

In chapter 2, I explicate my approach to legal interpretation. I provide numerous conceptual tools and distinctions and provide examples of how legal interpretation should be understood (and how it should not be understood). This chapter sets up the framework for the interpretative and legislative suggestions that follow throughout the rest of the thesis. It is found that pragmatic tools to aid interpretation are difficult to come by. It is suggested that ambitious interpretative proposals must proceed along principled criteria and cannot remain unsubstantiated. It is concluded that interpretative moves that do not follow self-evidently from legal content have to be justified.

Chapter 3 is devoted to an analysis of the solvency and liquidity requirement, which forms the foundational or base requirement of the law on distributions under the new company law system. The chapter shows that the solvency and liquidity test constitutes an appropriate limitation on distributions to shareholders. The more specific mechanics of its operation, as prescribed by the 2008 Act, however, are found to be unsatisfactory. It is concluded that substantive revision will be crucial in this area. I conclude that the purposes of section 7 do not play a role in the interpretation of solvency and liquidity. I suggest it is more beneficial to give content to the distribution provisions with reference to the dynamics of solvency and liquidity.

Chapter 4 attempts to untangle and clarify the opaque relationship between the authorisation of a distribution and the acknowledgement of solvency and liquidity. It is clear that this relationship has not been coherently conceived. I note the interdependence between the requirement of solvency and liquidity on the one hand, and the authorisation of the distribution and the acknowledgment of solvency and liquidity on the other.

Chapter 5 deals with the question of liability for unlawful distributions. It is concluded that the problems elucidated in the previous chapter have a knock-on effect on the question of liability for unlawful distributions. The interdependence and interplay between solvency and liquidity, the requirements for distributions, and the liability of directors is established. It is suggested that efficiency, good sense, and coherence on rare occasions require normative improvements to the text of the 2008 Act.

Chapter 6 briefly sets out some recommended provisions. This is the prescriptive chapter in which proposals for textual improvements to the relevant provisions of the Act are advanced. The provisions are meant to serve as a template for future reforms.

I use single quotation marks where I am not quoting the legislation verbatim. Single quotation marks are used for my own quotations (where I introduce my own examples, for instance), terms of art and the like. For the most part, I use double quotation marks where I am quoting actual legislative provisions, cases, journal articles, and so on.

It should be noted that the issue of share repurchases is not covered in this thesis.

Each chapter, barring the current, penultimate and final chapters, open with an introduction and end in a conclusion. Thematic conclusions are thus drawn in the designated chapters. Chapter 7, the overall concluding chapter, accordingly reverts back to a more philosophical viewpoint. The chief conclusions are, nevertheless, concisely summarised in the final chapter, as I provide answers, collectively, to the research questions.

Chapter 2

How to interpret the 2008 Act. Philosophical justifications: interpretative conservatism or interpretative activism or neither?

2.1 Introductory

“Analytic philosophy at its best uses logical rigour and semantic sophistication to achieve a sharpness of philosophical vision unobtainable by other means. To sacrifice those gains would be to choose blurred vision. Fortunately, good vision is not restricted to looking at eyes.”⁹⁸

In the light of the research hypothesis, an account of the philosophical bases of meaning and interpretation is necessitated. But – to begin at the beginning and no doubt to tease out the obvious – why should legal interpretation be invoked at all in an analysis of corporate law? The law makes itself felt, not only in the course of judicial application, but also in its intrinsic normative force: actors invariably endeavour to and (mostly) do tailor their conduct in accord with legal prescriptions, on pain of an injurious encounter with the public force. The act of interpretation is pervasive, and indeed constitutes the very life-blood of the law: besides judicial enforcement, regular subjects (citizens) in one way or another have to engage in the activity of legal interpretation. It is in our *understanding and application* of (corporate) law where the import of (corporate) regulation manifests, not its mere (abstract) enactment. Naturally my focus falls on legal interpretation as the legally authoritative resolution of questions concerning what the content of (company) law is in its concrete application to specific cases.

At many junctures decisive interpretative decisions have to be made due to the terminologically muddled waters of the 2008 Act. Either the interpreter sticks rigorously to the letter of the law; or she engages in interpretative gymnastics, taking semantic liberties, in order to streamline (or advance some policy goal, i.e. efficiency, fairness, and the like). Legal theorists usually frame this interpretative decision as an embodiment of the choice between *literal* application – that is, strictly discerning the grammatical, ordinary or semantic meaning

⁹⁸ Williamson “Past the linguistic turn?” in B Leiter (ed.) *The future for philosophy* (2006) 128.

of a provision – and *purposive* interpretation, which allows for the actualisation of underlying goals or values (and occasional departures from the letter of the law).⁹⁹

The former method can be said to be marked by judicial (or interpretative) conservatism: the interpreter is merely gauging and implementing the legislature's legal pronouncements as it enacted them. The exercise is usually characterised as descriptive or factual. This theory is routinely justified by reference to the rule of law, the separation of powers, judicial deference, and so on. This approach is usually criticised as defunct and unrealistic – as laudable values and policy objectives are obscured, and the law-maker's intent is occasionally obfuscated – and has fallen out of favour in recent times. The latter method – the purposive theory – can be fairly dubbed the prevailing theory in statutory interpretation today. This activity is usually thought of as normative or evaluative. It is deemed to have the advantage of more realistically effecting relevant policy objects, as well as more accurately capturing statutory intent. Its primary drawback is thought to be its vulnerability to interpretative (judicial) opportunism.

My submission is that the above picture is confused: it represents profound linguistic confusion, and is philosophically specious. Now, my ultimate aim is to justify interpretative decisions I (will later) make in respect of the distribution provisions enshrined in the 2008 Act. But, to this end, I cannot later propose, for example, the literal interpretation of a given provision if this very notion (as is the case with purposivism) is part of a misguided picture of the interpretative dilemma sketched above. Hence, I first need to frame the debate in a conceptually cogent manner. After that I will have to offer philosophical and authoritative support for a particular interpretative method or framework. On the strength of that interpretative picture, I can justifiably put forward specific ways in which potentially absurd or opaque provisions should be interpreted.

This is also to say: far from lurking in the shadows of purposivism (itself a somewhat fuzzy notion), judicial opportunism in fact rather lurks precisely where a unified, philosophically sophisticated picture of interpretation is absent. In other words, in the absence of such a theory, novel or inventive interpretative proposals invariably smack of arbitrariness – which,

⁹⁹ Eskridge *Dynamic Statutory Interpretation* (1994) 4; Du Plessis *The Interpretation of Statutes* (1986) 35-36.

as any jurist knows, is anathema in the theory and practice of the law. So, why is the dispute between literalists and purposivists mistakenly conceived?

2.2 The Conflation of Meaning and Assertion, and other Conceptual Blunders

The reason for the confusion consists chiefly in running together meaning and assertion.¹⁰⁰ Before I flesh this out, it has to be noted that legal interpretation has two sides: an epistemic and a constitutive one.¹⁰¹ The epistemic aspect involves determining the content of the law as it is. The constitutive task consists in making an authoritative decision which itself co-determines what the content of the law is.¹⁰² Importantly, on occasion this authoritative decision or judgment *changes* the content of the law that was considered in the epistemic task.

So what can be said to be *the content* of a particular law? This is the critical question. This is where the confusion most legal theorists labour under comes in. The problem is that lawyers and legal scholars are not sufficiently informed as to how the content of positive law is related to its authoritative sources. These authoritative sources are necessarily *linguistically created*. To put the dilemma alternatively: lawyers are routinely not privy to what determines the contents of ordinary linguistic texts.

To simplify: textualists or literalists think the content of the law is seated in the semantic or natural meaning of the sentences composing the relevant legal materials. Purposivists regard the content of the law as the underlying purpose (value, or normative goal) of the sentences composing the relevant legal provisions. Because these respective approaches err in their conception of what constitutes the content of the law, neither can be accepted as a plausible

¹⁰⁰ See the illuminating work of Scott Soames on this (and related issues); Soames “Interpreting Legal Texts: What is, and What is Not, Special about the Law” (March 2007) http://www-bcf.usc.edu/~soames/sel_pub/Interpreting_Legal_Texts.pdf (accessed 07-08-2011); Soames “What Vagueness and Inconsistency Tell Us About Interpretation” (12-06-2010) http://www-bcf.usc.edu/~soames/sel_pub/Vagueness_Inconsistency_Interpretation.pdf (accessed 07-08-2011) or “What Vagueness and Inconsistency Tell Us about Interpretation” in A Marmor & S Soames (eds) *The Philosophical Foundations of Language in the Law* (2011); Soames “Toward a Theory of Legal Interpretation” (2011) http://www-bcf.usc.edu/~soames/forthcoming_papers/ (accessed 07-08-2011).

¹⁰¹ ‘Epistemic’ or ‘epistemological’ refers, generally speaking, to what one can humanly know; it concerns the theory of knowledge. ‘Constitutive’ here invokes ontological overtones: the concern is not with what it is possible to know, but rather with what *is*. (‘Ontology’ denotes doctrines about the nature of reality, of what is.) The difference between ontology (constitutive matters) and epistemology (epistemic matters) is therefore the difference between questions regarding what *exists* and questions about how we *know* what exists.

¹⁰² Soames “Toward a Theory of Legal Interpretation” (2011) http://www-bcf.usc.edu/~soames/forthcoming_papers/ (accessed 07-08-2011) 1.

interpretative theory. Hence, normally a literalist characterises the content of a legal text (i.e. the law it enacts) as the (semantic) – the natural or ordinary or dictionary – meaning of the text. But – and this is crucial – as the pre-eminent contemporary analytic philosopher Scott Soames makes clear:¹⁰³

Contemporary philosophy of language and scientific linguistics distinguish the meaning of a sentence from its semantic content relative to a context, both of which are distinguished from (the content of) what is said, asserted, or stipulated by an utterance of the sentence. Although in some cases the three types of content coincide, while in still others the final two do, there are a variety of cases in which the third differs from the other two. In every legal case in which there is such a difference, it is the third – asserted or stipulated content that is required by any defensible form of textualism. Failure to recognise this – due to confusing the three types of content with one another – has led to serious errors in the law itself, as well as to theoretical errors about the relation of the law to its authoritative sources.

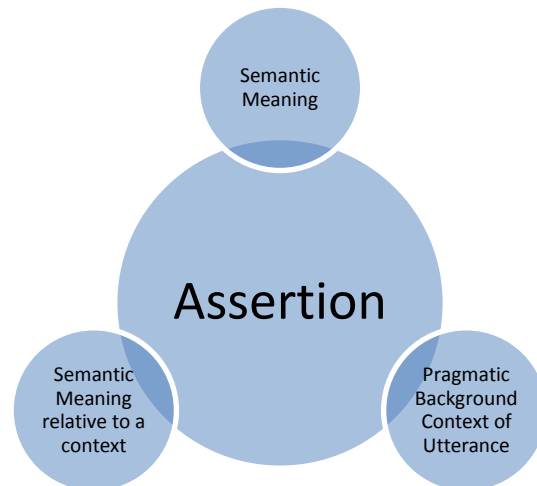
And to elaborate, consider the following:

Just as *what I say*, and commit myself to, by uttering a sentence, is often a function of more than its semantic content, so “what the law says,” and is committed to, is often a function of more than the semantic contents of relevant legal texts. Just as you have no standing to reinterpret my remark to conform to your moral and political views, *simply because the meaning of my sentence doesn't fully determine the content of my remark*, so judges applying the law have no standing to reinterpret it, *simply because the linguistic [semantic] meanings of the relevant legal texts don't fully determine the content of the law*.¹⁰⁴

The broad idea can be illustrated by way of a diagram.

¹⁰³ Soames “What Vagueness and Inconsistency Tell Us About Interpretation” (12-06-2010) http://www-bcf.usc.edu/~soames/sel_pub/Vagueness_Inconsistency_Interpretation.pdf (accessed 07-08-2011) 15.

¹⁰⁴ Soames “Interpreting Legal Texts: What is, and What is Not, Special about the Law” (March 2007) http://www-bcf.usc.edu/~soames/sel_pub/Interpreting_Legal_Texts.pdf (accessed 07-08-2011) 2 (emphasis in the original).



‘Assertion’ is what gives the content of the law (just as it makes up the content of our utterances in conversation). ‘Semantic meaning’, roughly speaking, comprises the relatively stable, abstract, conventionally fixed meanings of words in the public language. ‘Semantic meaning relative to a context’ refers to the context-dependence of the latter: context should make clear whether, in using, for example, the word ‘fair’, I mean ‘light in colour’ or a sense of ‘rightness, justice, impartiality, etc’. (The dictionary tells us all the possible meanings or senses of any given word – semantically speaking.) Though indeed context-bound, this type of ambiguity occurs at the semantic level; it is a *semantic* ambiguity. It is entirely distinguishable from the broader *pragmatic* context in which a speech act is performed, or indeed, legislation is adopted. ‘Pragmatic background context of utterance’ therefore denotes the wider situation in which speakers (legislators) and interpreters find themselves: the general institutional (legislative) setting, a corporate or commercial way of understanding certain terms, and other relevant factors necessary to comprehend the (statutory) utterance. Each of these three elements co-constitutes what is asserted. The relative contribution of each element to what is asserted is intrinsically variable, and cannot be determined in advance.

So the correct view is that the content of a law is that which the authoritative lawmaker *asserts* (stipulates or otherwise prescribes by adopting an authoritative text).¹⁰⁵ So, as in an ordinary conversation, where the assertive content is not in general equivalent to the meanings of the sentences used, nor with the interlocutors’ purposes in uttering what they utter, the assertive content of a *legal* text cannot in general be identified with the semantic (ordinary) meanings of the sentences of the legal text, nor with the policy goals motivating

¹⁰⁵ Soames “Toward a Theory of Legal Interpretation” (2011) http://www-bcf.usc.edu/~soames/forthcoming_papers/ (accessed 07-08-2011) 1.

lawmakers.¹⁰⁶ It follows that literalism is false, but so is purposivism: the content of a legal text can also not be identified with any normative improvement of what the relevant lawmakers asserted.

Traditional literalism is mistaken for another reason. I said that legal interpretation has two aspects: epistemic and constitutive. When interpreting a legal provision, one's task is first and foremost epistemic: one has first to discern the content of the law. Literalists are (in)famous for denying or playing down the constitutive role of interpretation. When confronted with inconsistency, vagueness or opaqueness in the law, they turn to dictionaries and the dictates of conventional usage, in the hopes of discovering hard-to-discern legal content that is 'already there'.

Their efforts are better spent *justifying* the introduction of novel legal content, in the case of a vague or unclear legislative provision: it cannot be denied, *contra* literalism, that the courts have a (very) legitimate (if secondary) legislative or law-making role to play – which is of course tempered by a principle of judicial deference. So literalism is ill-conceived for at least two reasons: one, it cannot correctly gauge legal content because legal content can almost never legitimately be said to be the equivalent of the semantic meaning of the sentences comprising the relevant legal rule. Existing legal content is neither original intent, nor is it original meaning: it is rather the content originally *asserted* by lawmakers in enacting or adopting the legal text in question.¹⁰⁷ Two, it denies the ancillary – though genuine and indispensable – role the judiciary plays in making new law, or changing (epistemically identified) legal content.

So errors in the law can result because literalists confuse three different types of content – the meaning of a sentence, its semantic content relative to a context, and what is asserted. Conflating meaning and assertion is ubiquitous in legal theory and practice. The consequence is a confusion of two distinct interpretative precepts: fidelity to the meaning of the lawmaker's legislative language versus fidelity to the content of what the lawmaker asserted *in using that language*.¹⁰⁸ I want to illustrate the foregoing with two examples: this will show how (often) momentous matters can turn on seemingly pedantic linguistic squabbles; getting

¹⁰⁶ 1.

¹⁰⁷ 6.

¹⁰⁸ 6.

the facts about language right matters. Scott Soames is fond of using the following real-life case of *Smith v United States* which was decided by the US Supreme Court not too long ago.¹⁰⁹ I will detail the main points briefly and thereby also touch on the issue of the role of legislative intent in legal interpretation (about which more will be said later on). The issue was whether Smith's attempt to trade a firearm for drugs constituted *a use of a firearm* – if so, the law dictates that he incur additional penalties. No definition of 'use of a firearm' could be found in the legislation applicable to the matter. Hence, the court appealed to the semantic or ordinary (or natural) meaning of that phrase. The court's conclusion is that it is plain that attempting to trade a firearm for drugs constitutes *using the firearm within the everyday or ordinary meaning of that term*. Can one legitimately say: person X 'used' his firearm by offering it in exchange for drugs? Of course: that phrase can be ordinarily used thus, and since ordinary use is the assumed test for the content of the law, Smith did relevantly use his gun, and so must incur additional penalties.

But is the court's assumption that the *content of the relevant statute is supplied by the ordinary, semantic meaning of the words used* legitimate? There was an interesting dissent by Justice Scalia: he says the ordinary meaning of 'use' cannot be said to include using a firearm in an attempt to trade it for drugs.¹¹⁰ Rather, to speak of 'using a firearm' is to talk about using it for its distinctive purpose, that is, as a weapon. So, his argument is: indeed one *can* 'use' a firearm as an article of exchange, but that is not the ordinary meaning of 'using'. To support this, he provides an example. He says the objective falsity requirement for a perjury conviction would not be met where a witness answers negatively to a prosecutor's question whether she had ever 'used a firearm', even though she once sold her grandfather's rifle to a rifle-collector.

Soames opines that the salient feature of this case concerns how "a shared conflation of *the meaning of the statutory language with the content of the resulting statute* leads to an incoherent debate in which the dissent and the majority talk past each other".¹¹¹ Indeed, the

¹⁰⁹ 508 U.S. 223 (1993). See Soames "Interpreting Legal Texts: What is, and What is Not, Special about the Law" (March 2007) http://www-bcf.usc.edu/~soames/sel_pub/Interpreting_Legal_Texts.pdf (accessed 07-08-2011) 12 - 15; Soames "Toward a Theory of Legal Interpretation" (2011) http://www-bcf.usc.edu/~soames/forthcoming_papers/ (accessed 07-08-2011) 8. The ensuing discussion is based on the former.

¹¹⁰ Soames "Interpreting Legal Texts: What is, and What is Not, Special about the Law" (March 2007) http://www-bcf.usc.edu/~soames/sel_pub/Interpreting_Legal_Texts.pdf (accessed 07-08-2011) 13.

¹¹¹ Soames "Interpreting Legal Texts: What is, and What is Not, Special about the Law" (March 2007) http://www-bcf.usc.edu/~soames/sel_pub/Interpreting_Legal_Texts.pdf (accessed 07-08-2011) 14.

court was right to hold that ‘uses a firearm’ occurs in the text with its ordinary meaning; it is also correct to say that uses other than as a weapon (i.e. as an article of commerce) is included in its ordinary meaning. But the key is this: the court is wrong to think that this offers up the *content* of the relevant statute, “...the law that the statutory language was used to enact”, that this shows that *the law* includes uses of firearms other than as weapons.¹¹² In fact the natural or ordinary meaning is *silent* regarding the manner of use.¹¹³ The court should not pursue semantic meaning: because semantic meaning was silent about the manner of use, the task of the court “...was to infer *what Congress asserted* from the incomplete semantic content” in the legislation.¹¹⁴ What “...Congress should be taken to have asserted” is what the court should be after: Congress’ assertion was that “an additional penalty will be added to crimes in which a firearm is used *as a weapon*”.¹¹⁵ So, that the semantic meaning is open-ended or vague, and seems to include an almost unlimited number of cases, does not dictate *that the law is so undefined*.

For instance, the Circuit Court of the District of Columbia in this dispute took the following line: even if the legislature understood itself as prohibiting only a narrow range of uses of a firearm (i.e. uses as a weapon) – even if that is the legislature’s assertion – this is not the end result or what it achieved because the semantics it used did not expressly exclude a broader range of cases.¹¹⁶ This line of reasoning is patently absurd. Putting aside for the moment the fact that previously unanticipated cases inevitably always arise, a piece of legislation cannot ever exhaustively cater for every eventuality; this is owing to the nature of language, namely that it is invariably and irreversibly vague and open-ended. It is wholly untenable to lay the basic fact of vagueness at the doorstep of the legislature. This point is trite in the philosophy of language and in scientific linguistics. For some reason, many jurists have failed properly to digest it. They have failed to process the following datum: semantic meaning routinely (radically) *underdetermines* the entire linguistically based content of an utterance or of the law (i.e. assertive content). Interpreters (judges) should always try to gauge what the legislature asserts or stipulates, not what the words used in the assertion mean.

¹¹² 14.

¹¹³ 14.

¹¹⁴ 14.

¹¹⁵ 15.

¹¹⁶ 15.

It would not be hard to cite such instances occurring in South Africa (or, for that matter, anywhere else). Just as in America where the top court in the country fatally confused meaning and assertion, our own Constitutional Court was recently responsible for that very same blunder, in *Justice Alliance of South Africa v President of the Republic of South Africa and Others* ('the *Justice Alliance* case').¹¹⁷ There the court (quite disconcertingly) opined that it is "obliged to determine objectively the meaning of the constitutional provision [in question] irrespective of the meaning as perceived by Parliament."¹¹⁸

This case concerned whether Parliament had prescribed a constitutionally acceptable procedure for the extension of Ngcobo CJ's term as Chief Justice. The legislation which in section 8(a) afforded the president the power to extend Ngcobo CJ's term was apparently adopted at the same time as the relevant constitutional amendment which provided for parliamentary extension of such terms. Appealing to the semantic meaning of the constitutional text as the definitive criterion for the identification of a constitutional rule (i.e. to simplify, the semantic meaning of the rule stipulating '*only an act of Parliament* can extend the term of office of a Constitutional Court judge [beyond the legally stipulated period]'), the court shuns the argument that, owing to the contemporaneous enactment of both laws, Parliament was 'open-eyed' in adopting both laws and did not understand itself to be adopting a statutory provision in conflict with the constitutional amendment.¹¹⁹ The interpretative approach the court employs is strikingly spurious: the court thinks it can override the legal assertion Parliament effected, by reference to the stringent semantic meaning of the words Parliament employed.

Disconcertingly, the court implicitly says the way in which Parliament understood the law (i.e. the legal assertion Parliament enacted) is *not* binding on the Constitutional Court (i.e. the way in which the Constitutional Court has to interpret the law). The doubtful validity of this stance should be patently obvious. Such an approach would, given the open-endedness of language (*a fortiori* the language of constitutions), warrant judicial opportunism. Over and

¹¹⁷ *Freedom Under Law v President of Republic of South Africa and Others, Centre for Applied Legal Studies and Another v President of Republic of South Africa and Others* [2011] ZACC 23; CCT 53/11, CCT 54/11, CCT 62/11 (29 July 2011).

¹¹⁸ Para 60.

¹¹⁹ Though I cannot here properly elaborate why, I think the decision the court ultimately reached (relying on this questionable semantic meaning approach) was the correct one. My view calls into question the correctness of the premise that Parliament *in fact* understood itself to be adopting a statutory provision harmonious with the constitutional amendment.

above obvious theoretical problems, what legitimate (authoritative) grounds exist upon which the Constitutional Court can insist, where Parliament's intended content is discernible, that its interpretation should prevail over that of Parliament? Besides preposterously laying the basic fact of linguistic vagueness at the doorstep of the legislature, the Constitutional Court, then, also unwittingly opens a Pandora's Box of issues involving the hierarchy and authoritative bases of the respective branches of the state.¹²⁰

As I noted earlier, this conceptual confusion is entangled with the question of the relevance of legislative intent. I also said that the entire dispute between literalists and purposivists is misconceived. Neither theory accurately represents the way language works. The dispute, and the respective contribution of each approach, is essentially irrelevant. This is so because they both commit the fallacy of conflating meaning and assertion. I also say this debate is misconceived because these outlooks or theories indefensibly overlap. For instance, the Constitutional Court is generally thought to be an advocate of purposivism (or some kind of value-activating variant thereof); however, this cannot be squared with the categorically literalist (textualist) dictum of the *Justice Alliance* case which I cited earlier. Yet another reason for the speciousness of the traditional alternatives (literalism and purposivism) – and this finally brings me to the issue of intent – is their ill-advised dismissal of the role of legislative intent in legal interpretation.

Legal theorists have, in recent times, taken to professing the irrelevance of legislative intent. The fact that the agent of a 'legislative speech act' is usually not a single language user but a group must be a big part of the reason for this. It is common to think that striking epistemic problems render it impossible to discern true intent. Literalists often fear an interpretative blank cheque in terms whereof interpreters are able to advance their own policy preferences under the pretext of gauging real legislative intent. The idea is that legislative intent is basically illusory: the model of the more or less unitary cognitive (intentional) state of an individual cannot easily be extrapolated to the context of statutory law-making. Purposivists thus normally ignore an investigation into intent and instead pursue the underlying purposes or values seated in legal provisions.

¹²⁰ It is submitted that my own interpretative proposal steers clear of such weighty political philosophy concerns, in that no such justification is called for. Alternatively put, the interpretative suggestion I put forward represents a more coherent and intuitively plausible account of the separation of powers doctrine.

But linguistic meaning cannot be said to have priority over all the intentions of the legislature; as well, appeals to intent are still necessary even where linguistic meaning is clear.¹²¹ Thinking otherwise is again attributable to the fallacy of confusing meaning and assertion: it must be borne in mind that what language users *intend* to assert constitutes an integral element – together with the semantic meaning of the words used – in forming what they *actually do* assert. In this way “...the intentions of lawmakers are directly relevant to the contents of the laws they enact”.¹²² In this sense legislative intent can be constitutive. Often such constitutive intentions will be easily discerned, and so too the relevant assertive contents: in this sense only, intention can be said to be unimportant, since no further appeal is required in order to identify the completed assertion (the legal content).

The dismissal of intent – confused though it may be – derives usually from a well-founded interpretative principle which is associated with notions like judicial deference, the separation of powers, the rule of law, and the like. Courts are tasked with, not creating or changing, but *interpreting* or *applying* the law enacted by the legislature: constitutive changes in the content of the law must be avoided save in special cases. This is correct. The problem in traditional legal theory is that the concept of ‘intent’ or ‘legislative intent’ is not sufficiently rigorous. One has to bear in mind the fundamental distinction between illocutionary intentions and perlocutionary intentions.¹²³ Illocutionary intent provides the law’s content: it instantiates an assertion by virtue of one’s audience recognising one’s intention to do so. Perlocutionary intent consists in causing or effecting something as a result of one’s assertion. This distinction is descriptive (factual): the existence of such a distinction cannot be doubted.

I will illustrate the conceptual point with a simple example. Imagine the following (ridiculous) situation: a small community has a town council which has the responsibility to legislate on matters affecting the community; it has a small tribunal of sorts settling disputes as well. Of late an alarming amount of children belonging to the community have been harmed by cars speedily reversing from their driveways into the streets of the community where the children often play. Measures were subsequently taken to ensure drivers would be especially vigilant and cautious with respect to children playing games in the streets of the community. After further investigation it was found that a major contributing factor to the

¹²¹ Soames “Interpreting Legal Texts: What is, and What is Not, Special about the Law” (March 2007) http://www-bcf.usc.edu/~soames/sel_pub/Interpreting_Legal_Texts.pdf (accessed 07-08-2011) 9.

¹²² 10.

¹²³ See Austin *How to do things with words* (1962).

increasing amount of incidents of children being harmed in this way was that children of the community had become engrossed with playing a particularly addictive game specifically apt to be played in the streets. The town council thus (rather rashly) saw fit to legislate to the following effect: *'it shall be a misdemeanour, subject to specified penalties, if a member of the community plays a game of any sort in any of the streets of the community'*. Policeman Paul then encountered Father Frank passing a rugby ball with his son (Simon) partially in a community street and partially on Frank's driveway.

What are the legally relevant intentions here? The town council here enacted a law by adopting a text with the illocutionary intent that its linguistic performance be recognised as asserting that members of the community who play games in the community streets thereby commit a misdemeanour. This illocutionary intent supplies the content of the relevant law; it is constitutive of the resultant (legal) assertion. A correct understanding of the relevant legal assertion *entails* the proper comprehension or identification of illocutionary intent. For this reason, illocutionary intentions cannot be done away with in any theory of legal content or of legal interpretation. Recall that the perlocutionary intent is the intent to effect a certain result owing to one's assertion. Here the perlocutionary intent is the intention by the council to reduce or eliminate bodily harm to children, primarily arising from motor vehicle collisions. That is to say, the perlocutionary intent is the larger reason or purpose (the public policy being advanced) behind the legal content (the legal content, that is, which encapsulates illocutionary intent).

Legal interpretation starts with the epistemic task – that is, the starting point is the attempt to discern legal content (the entire linguistically based assertion); it is not an attempt to discern linguistic or semantic meaning (since, as I have said, this normally underdetermines what is said or asserted). So it is the job of the courts (and normal interpreters) to *identify*, not invent or modify or normatively 'improve', in the first instance, what the lawmaker has asserted by adopting the relevant legal text. If this epistemological task can easily be achieved – so that assertive content is accurately gauged – legal interpreters may ignore the lawmakers' perlocutionary intentions save in certain special cases.

Naturally this sounds easy and is somewhat oversimplified. But it actually is theoretically sound. In other words, the epistemological aspect of interpretation should not be overemphasised or regarded as having a monopoly over legal interpretation; that is to say, the

existence of special cases should not be played down. An analysis of these exceptional cases is a complex and fundamentally important matter which I cannot adequately (fully) tackle in this thesis. One such case – which I will presently discuss – is vagueness. Thus, if the asserted content is vague – one cannot therefore epistemically gauge legal content – and the facts essential to the resolution of the case in question fall within the scope of said vagueness, then the task of interpretation becomes *constitutive*. This means that the act of interpretation has to constitute or make the law (within principled limits): an authoritative decision by the court will itself co-determine the content of the (epistemically uncertain) law. In other words, where such vagueness is encountered – or where another such special case presents itself – interpreters or the courts will have to appeal to perlocutionary intentions. HLA Hart makes the following observations regarding the character of vagueness:¹²⁴

In all fields of experience, not only that of rules, there is a limit, *inherent in the nature of language* [my emphasis], to the guidance which general language can provide. ... Whichever device, precedent or legislation, is chosen for the communication of standards of behaviour, these, however smoothly they work over the mass of ordinary cases, will, at some point where their application is in question, prove indeterminate; they will have what has been termed an *open texture* [emphasis in the original].

Therefore, if the assertion provided by the content of the law is vague and the facts essential to the resolution of the matter at hand falls in the range of such vagueness, the law as it is – factually – does not dictate the correct result. That is to say, descriptively – speaking to the epistemic side of interpretation – the law runs out. Hence it is with respect to the constitutive side of interpretation in which normative or evaluative considerations inevitably crop up; put simply, the interpreter is then, properly speaking, faced with a *choice*, in attempting to resolve the vague case.

Why should this be so? Again, no one has put it more eloquently than Hart:

[T]he reason is that the necessity for such choice is thrust upon us because we are men, not gods. It is a feature of the human predicament (and so of the legislative one) that we labour under two connected handicaps whenever we seek to regulate, unambiguously and in advance, some sphere of conduct by means of general standards to be used without further official direction on particular occasions. The first handicap is our relative ignorance of fact: the second is our relative indeterminacy of aim.

¹²⁴ Hart *The concept of law* (1994) 126, 128.

Previously unanticipated facts continually crop up. It is easy to suppose that the legislature foresees piecemeal enrichments of legal content by the judiciary. Alternatively put, the legislature knows it is not God; we all know this. Incremental exceptions can legitimately emerge by judicial sharpening. The legislature should be regarded as being aware that such sharpening or enrichment is unforeseeable in advance and is best effected incrementally by the courts. Perhaps surprisingly, the basic fact of vagueness is often useful: passing a law creates a strong, but defeasible, assumption that behaviour contrary to it is discouraged; couching the law in broad language gives an incentive to refrain from behaviour which might fall into that category.¹²⁵ In other words, it may sometimes be a good thing that, owing to the vagueness of legal prescriptions, people *oversubscribe* to those prescriptions: the larger reason or purpose may be more frequently actualised.¹²⁶ And, the recognition that legal content is (judicially) defeasible diminishes the drawbacks associated with an excessively universal description of the stipulated behaviour.

So, not only is the original assertive content, enacted by the adoption of a certain provision, much richer and more nuanced than the literal meaning of the sentence(s) used to express it, this original assertive content cannot be said to encompass all further exceptions and sharpening which is the result of legitimate interpretation and judicial application. The legitimacy and necessity of constitutive interpretation is borne out in the case of vagueness. Normative judgments regarding which modifications of existing legal content best promote the legislative rationale will sometimes be required. Clearly, in my example above, Father Frank and (son) Simon passing a rugby ball partially on the community street should not be included in the legal provision's extension; including this instance would probably have an effect contrary to advancing the relevant normative goal. The difficult question, naturally, is when a slide from epistemic interpretation to constitutive interpretation is warranted. When can one move from mere identification of existing assertive content, to effecting positive changes in the law's content? I have already discussed vagueness, which is one such case. (To recap: here the full linguistic contents of the controlling legal materials and the relevant facts fail to yield any determinate outcome.)¹²⁷

¹²⁵ Soames "Interpreting Legal Texts: What is, and What is Not, Special about the Law" (March 2007) http://www-bcf.usc.edu/~soames/sel_pub/Interpreting_Legal_Texts.pdf (accessed 07-08-2011) 14.

¹²⁶ These gains are not total; 'oversubscribing' can also hamper efficiency. The result could be that important economic activities are delayed or neglected.

¹²⁷ 19.

Another is when an outcome *is* determined by the relevant legal materials but is legally *incorrect*.¹²⁸ So a single result is dictated by the full linguistic contents of the authoritative legal materials but it is legally wrong. More precisely: the existing law and the facts of the case entail an unforeseen verdict which does not advance the purposes for which the law was adopted, whilst also violating either its rationale or the rationales of other laws.¹²⁹

Frank and Simon's case probably qualifies as such an instance. It cannot be legally correct to hold either of them liable under the relevant provision. As I have argued, the literal meaning of the words used does not give the content of the law. But even the assertive content in this imagined case does not seem rich enough to provide the correct result (in which Frank and Simon are innocent). Can the assertive content of the rule be deemed to be something along these lines: it is prohibited that *members play games likely to injure children*, so that Frank and Simon are not targeted because their innocent passing game is not likely to harm anyone? Frank is supervising and can oversee matters, thereby diminishing the likelihood of injury. After all, the law originated because children (without supervision) became engrossed with a particular game (not supervised rugby ball passing), resulting in decreased vigilance by the involved children, and ultimately in their injuries. But it still seems a stretch to so limit the assertive content. (There is after all a distinction between what one actually says in a given context and what one would say, if one thought about it more carefully.)¹³⁰ If so, we have crossed over to constitutive interpretation and the move is justified in order to avoid a legally incorrect result.

This does not show that judges have the authority to "...rewrite laws the literal application of which would violate their own views of what *should, or shouldn't* be legal".¹³¹ Rather, because most laws are somewhat indefinite and broad, judges are authorised to effect small modifications to harmonise it with what the lawmaker was trying to accomplish, where the

¹²⁸ 16. As mentioned, I cannot expound each special case in detail. Appropriate elaboration is provided in case such an instance emerges in corporate regulation later.

¹²⁹ Soames "Toward a Theory of Legal Interpretation" (2011) http://www-bcf.usc.edu/~soames/forthcoming_papers/ (accessed 07-08-2011) 13.

¹³⁰ 17.

¹³¹ 18.

literal application of a law to a case contravenes the clear intent guiding the lawmakers in adopting it.¹³²

The final instance in which constitutive changes may be warranted, and perlocutionary intentions may be relevant, is when a set of facts generates an inconsistency, not between a law and the purposes for which it was adopted, but between the content of one or more equally authoritative laws, so that inconsistent verdicts are entailed by the contents of the laws and the specific facts of the case.¹³³ The interpreter then has to “...fashion the minimal modification of existing legal content that removes the inconsistency and allows a single unique verdict to be reached, while maximising the fulfilment of the discernible legislative rationales of the laws in question”.¹³⁴

2.3 Towards the Outlines of a Theory of Legal Interpretation (or Some Interpretative Guidelines and Useful Distinctions and Concepts)

As just indicated, I want to explain a brief *outline* here, not (*per se*) a theory. Mainly I want methodically (and tersely) to bring together some of the theoretical points expounded above. The larger point of this is that getting the theory and the philosophy right from the outset should enable me to do at least two things. I will be equipped, first, with the necessary rigour and conceptual apparatus to deal with the terminological problems in the Act in a sophisticated manner. Secondly, the interpretations and proposals I offer up later will stand on firmer theoretical (authoritative) ground and so should not be legally empty. Now scientific linguistics and the philosophy of language are highly technical fields, the most important recent advances of which are not easily accessible to the jurist. But I believe the most pertinent lessons can be outlined (as I have already attempted above) without gross oversimplification.¹³⁵ I briefly enumerate the necessary guidelines below.

¹³² 18-19 (emphasis in the original). Literal application here refers to an interpretation in accordance with the strict semantic meaning of the laws in question.

¹³³ 12.

¹³⁴ 12.

¹³⁵ The esoteric nature of these fields is perhaps their greatest shortcoming; illuminating advances are too often restricted to small groups of experts. In order to achieve the greatest clarity and accessibility, technical terminology will be kept to a minimum, i.e. will only be utilised when indispensable.

First: there can be no serious argument supporting the conclusion that a specific law requires exactly what its words seem literally to mean. Just as what a speaker conveys often fails to be fully determined by the linguistic meaning of the sentences uttered, the content of the law is often not supplied by the mere linguistic meaning of the sentences used to enact it. Semantic (conventional) meaning often radically *underdetermines* the assertion intended to be conveyed; literal meanings thus cannot give the content of the law. Meaning, therefore, is sometimes but a guide to interpretation.

Second: vagueness (explained above) is a fundamental fact of language.¹³⁶ In part because of this, the previous point holds water. Hart spoke of the open texture of language; language philosophers refer to the austerity, non-transparency or indefinability of meaning. Roughly, a linguistic (legal) text is vague when it is insufficiently precise to advance a certain aim in a certain context, e.g. a legal dispute: the phrase on which the case turns is not clear-cut enough to dictate a verdict. More technically: a vague provision is one which is susceptible to borderline cases, in that there is no rigid boundary between instances where the term applies and instances where it does not. Is a skateboard a 'vehicle'? Does it constitute a relevant 'use' if you use a gun to trade it for drugs? What are the necessary and sufficient conditions for the application of a term like 'game'? Most of our linguistic terms defy exhaustive or rigorous description: necessary and sufficient conditions for the application of linguistic terms are seldom in the offing. And usage by competent speakers is the highest authority regarding the issue of the proper application of a linguistic term. The important lesson for the law is this: that the language used is capable of different (variable) content in some other context is irrelevant. We need to discern the lawmaker's assertion by gauging the meaning together with the specific contextual features in which the lawmaker enacted the law. So we must go beyond meaning if we are to gauge legal content tenably. The open-endedness or vagueness of language, in other words, cannot be laid at the doorstep of the legislature.

Third: following from the second point, legal content must be seated in the entirely linguistically based content of a legal text, on pain of committing the fallacy of conflating meaning and assertion. There is a relatively systematic set of relations which holds between the semantic (conventional) meaning of a sentence, and the peculiar (pragmatic) content

¹³⁶ Vagueness is one of the largest and most exciting emerging areas of inquiry within the philosophy of language. Naturally, I gloss over the myriad technical intricacies and difficulties involved.

expressed by a sentence on a specific historical occasion.¹³⁷ Simply put, there is a distinction between (conventionally determined) semantics, and (historically, contextually determined) pragmatics.¹³⁸ Pragmatics, simply put, concerns “whatever information is relevant, over and above the linguistic properties of a sentence, to understanding its utterance”.¹³⁹ Legal content is the resultant assertion arising from the semantic-cum-pragmatic information-generating process.¹⁴⁰ It is thus possible, and often necessary and legitimate to invoke contextual features in order to discern legal content: the context of a relevant statute in its entirety, background assumptions inherent in a certain practice or field of law, historically determined features, and the like.

Fourth, intention is the central, organising concept weaving together these contextual features. It is important to remember the distinction between illocutionary and perlocutionary intentions (outlined above), and in particular, when the latter should be invoked.

Fifth: there is a distinction between epistemic and constitutive interpretation. The first and chief task of interpretation is (epistemically) to identify the relevant legal assertion (as I have been at pains to point out, *not the meaning*). In case one of the special cases laid out above emerges, the interpretative task becomes constitutive, whereby incremental changes may have to be judicially effected.

Sixth, there is a corresponding distinction between *semantically* hard cases and *genuinely* hard cases.¹⁴¹ This distinction hinges on the difference between the semantic content of legal texts and their entire linguistically based content (i.e. the complete assertive content); it also

¹³⁷ See in general Bach “The semantics-pragmatics distinction: what it is and why it matters” (1999) <http://userwww.sfsu.edu/~kbach/spd.htm> (accessed 29-05-2012). He states: “It is a platitude that a sentence’s linguistic meaning generally does not determine what is said in its utterance and that the gap between linguistic meaning and what is said is filled by something called “context”. The intuitive idea behind this platitude is that there are different things that a speaker can mean, even when using his words in a thoroughly literal way... . What one says in uttering the words can vary, so what fixes what one says cannot be facts about the words alone but must also include facts about the circumstances in which one is using them; those facts comprise the “context of utterance”” (7).

¹³⁸ Some philosophers of language speak of the distinction between sentence meaning and speaker meaning. I prefer to stay away from this classification because it paints a confused picture of ‘meaning’. Meaning is conventional and belongs under semantics; the speaker’s relation to his utterance is pragmatic, so that background assumptions and intentional features are at play here, and not semantic rules.

¹³⁹ Bach “The semantics-pragmatics distinction: what it is and why it matters” (1999) <http://userwww.sfsu.edu/~kbach/spd.htm> (accessed 29-05-2012) 10.

¹⁴⁰ Soames “Interpreting Legal Texts: What is, and What is Not, Special about the Law” (March 2007) http://www-bcf.usc.edu/~soames/sel_pub/Interpreting_Legal_Texts.pdf (accessed 07-08-2011) 2.

¹⁴¹ Soames “Interpreting Legal Texts: What is, and What is Not, Special about the Law” (March 2007) http://www-bcf.usc.edu/~soames/sel_pub/Interpreting_Legal_Texts.pdf (accessed 07-08-2011) 1.

corresponds, not rigorously, but roughly, with the epistemic/constitutive distinction. A case is semantically hard if its facts and the *meanings* of the relevant legal texts fail to determine the legally correct result. As I have been arguing, meaning is not equivalent to legal content: hence the interpretative (epistemic) task must go further, that is, the full linguistic (legal) assertion must be gauged. This task is still epistemic – one is discerning the original legal assertion and not improving or modifying it constitutively. Only when a case is *genuinely* hard is one called to interpret constitutively: that is where the *entire linguistically based content* embodying the pertinent law – i.e. the pragmatic (contextual) enrichments, on top of semantic meaning; in other words, the full legal assertion – and the relevant facts fails to determine the legally correct outcome.

This leads me to the seventh point: philosophy draws a distinction between descriptive (factual) matters and normative (evaluative, prescriptive) matters. This, again, roughly corresponds to the distinctions just drawn. In general, legal interpretation is a factual or descriptive task. This is also to say: the primary task of legal interpretation is epistemic – identifying the law enacted via authoritative sources – and not constitutive (constructing or modifying the law). Correspondingly, “...the slide from semantically hard cases to genuinely hard ones should be avoided”.¹⁴² This is the point I have been making all along: the proper object of legal interpretation is to ascertain the content of the relevant assertion; it is not to determine linguistic meaning. In other words, avoiding this slide is avoiding the fallacy of conflating meaning and assertion. In special cases, when a case is genuinely hard, we have to move, roughly speaking, from ‘the descriptive’ to ‘the normative’; in such genuinely hard cases, constitutive interpretation is necessitated.

A last – the eighth – thought: taking into account what I have said above, as well as taking vagueness seriously,¹⁴³ one might say the following: A legal rule can be said to represent a strong, but defeasible, assumption that behaviour contrary to it is discouraged.

2.4 Concluding Remark

¹⁴² Soames “Interpreting Legal Texts: What is, and What is Not, Special about the Law” (March 2007) http://www-bcf.usc.edu/~soames/sel_pub/Interpreting_Legal_Texts.pdf (accessed 07-08-2011) 2.

¹⁴³ In particular, I have in mind the fact that a complete assertion (the entire linguistically based content) – not merely the meaning – can also be vague, in the sense described earlier.

An obvious question is prompted: precisely *which* pragmatic (contextual) considerations, then, are relevant to the determination of legal content? I doubt that there is an easy, uncontroversial answer to this question. Often this will comprise self-evident background assumptions – e.g. in the *Smith* case described above: it can safely be assumed that the legislature asserted *use as a weapon/firearm* (and not some wider notion including using a gun as an article of exchange). These are commonsensical pragmatic tools. In addition, there must be *legal* pragmatic tools.

In this regard, chapter 1 of the 2008 Act is important, particularly sections 5 and 7. But, because these seem so abstract and excessively idealistic, it is difficult to see how these ‘values’ will be decisive in any interpretative dispute. In reality, it is likely that the traditional understandings and associations of commercial lawyers will remain. Perhaps this is not easily squared with the emphasis in the reform process on plain language. Moreover, since many of the sections in the 2008 Act are poorly drafted, a careful balance must be struck: on the one hand, quite an expansive licence for normative improvement may be afforded because of obvious errors, but, such interpretative modifications must be effected according to principled criteria and only where necessary, on the other. Though the articulation of the pragmatic elements to be considered in interpretation is a tricky matter, I think any attempt at its *exhaustive* articulation is counter-productive. The best approach is an ad hoc one: the key is to justify interpretative moves which do not follow self-evidently from the legal content. This is the method I will adopt throughout this work.

Chapter 3

The solvency and liquidity requirement

3.1 Introduction

Following the initially incomplete shift from capital maintenance to solvency and liquidity, the 2008 Act now makes a clean break with capital maintenance. It dramatically expands the scope of application of the solvency and liquidity requirement. Over and above being a necessary condition for all distributions, this requirement presents itself as a critical protective device in a great many transactions influencing the rights of creditors. Compliance with the requirement is also necessitated in the event of an amalgamation or merger,¹⁴⁴ where a company gives financial assistance in connection with the acquisition of its shares,¹⁴⁵ or makes a loan/gives other financial assistance to directors.¹⁴⁶ The importance of the concept to the new corporate law regime in South Africa cannot be overstated.

A single standard for the regulation of all corporate distributions to shareholders is thus introduced; and this was one of the main objectives of the company law reform process. The requirement is the decisive means by which the interests of creditors are safeguarded. A rigorous legal (and philosophical) analysis is required to make sense of the various mechanics of the test, as its content is not self-evident from the Act. As the requirement, *a fortiori* from the point of view of corporate creditors, comprises the fundamental condition for distributions, ascertaining its content and untangling its dynamics, could pave the way for a clearer understanding of the deeper logic or underlying motif of the distribution provisions. Concretely, the distribution provisions prescribe as requirements various conditions attaching to solvency and liquidity.

A coherent understanding of solvency and liquidity could profitably inform the content of opaque distribution requirements. At any rate, due to the prevalence of the concept in the provisions dealing with distributions, a clear understanding of its content is necessary. Before actually scrutinising the relevant sections of the Act, it is useful first to do two things. Briefly taking a normative (evaluative) line, it will be beneficial to consider wider views on the topic,

¹⁴⁴ Section 113(1) of the 2008 Act.

¹⁴⁵ section 44.

¹⁴⁶ section 45.

as well as broader rationales for mechanisms like solvency and liquidity. A brief discussion of pragmatic or purposive tools (as interpretative aids), in the second place, then follows. These points could well have a bearing on a cogent interpretation of the Act.

3.2 Normative Considerations

As an entry point into an analysis of the 2008 Act's provisions on solvency and liquidity, in order to gain some perspective on the legislature's apparent policy decisions and the chosen wording, it is useful first to raise some evaluative points.

Now the American influence in the 2008 Act is clear enough. The Model Business Corporation Act (the Model Act) is clearly felt in many of the provisions of the 2008 Act; the Model Act has been embraced as the foundational company law statute for thirty of the American states.¹⁴⁷ In this context, James Hanks has provided an interesting analysis of South Africa's new legal capital regime (understood as the rules covering contributions to capital by shareholders and distributions from capital to shareholders).¹⁴⁸ His analysis is particularly relevant, considering that he played an important role in devising the provisions of the 2008 Act.

While lauding many aspects of the new legal capital system ushered in by the 2008 Act – even noting that the 2008 Act improves in certain areas on the Model Act – he nevertheless believes there is room for improvement. He regards the level of creditor protection accorded by the 2008 Act as untenably high. In that sense, he seems to be representative of the mainstream liberal approach common in America. He doubts whether company law should even include provisions aiming at the protection of creditors when distributions are made to shareholders.¹⁴⁹ He opines that creditors do not place great weight on legal capital requirements like solvency and liquidity conditions at any rate.

He further states that the need for both a solvency and a liquidity element is overkill; that is, that only a liquidity element is necessary.¹⁵⁰ In short, the Act employs a twofold test: the solvency part requires that the assets of the company equal (or exceed) its liabilities, whereas

¹⁴⁷ Hanks "The new legal capital regime in South Africa" (2010) *AJ* 137.

¹⁴⁸ 131.

¹⁴⁹ 147.

¹⁵⁰ 147.

the liquidity aspect stipulates, roughly, that the company should be able to pay its debts as they become due in the ordinary course of business. Hanks sees no use for the former element, only believing the latter to be necessary. His argument goes as follows: if a company's assets exceed its liabilities but it is unable to pay its debts in the ordinary course of business, it is of no use to creditors¹⁵¹ Conversely, where there is a deficit of assets over liabilities but the company is able to pay its debts in the usual course of business, according to Hanks, there shouldn't really be a problem.¹⁵² In that sense, then, the solvency component is thought to be redundant.

Additionally, it is claimed that the solvency test tacitly assumes that all the liabilities are currently due and payable, but that this is hardly ever entirely the case.¹⁵³ The solvency element is thus not a reliable and useful yardstick of the financial situation of the company for creditors. It is deemed unduly restrictive. A disincentive for investors thus emerges, if this argument is sound. Knowing that it will be harder to obtain a distribution from the company in return for their investments, investors will be deterred. Hanks sees default rules, private ordering and transparency as the hallmarks of the company law statutes of the future.¹⁵⁴ He also questions whether the directors should be the 'ultimate guarantors' of the creditor protection mechanism (as they also approve the improper distribution) – noting moreover that often shareholders are also directors.¹⁵⁵ In light of fraudulent conveyance statutes and the protections of contract law, Hanks submits that no corporate law protection is needed – even for weaker, unsophisticated or unsecured creditors.

This throws up the question whether it is desirable to differentiate creditors and concomitant (levels of) protection. To be sure, corporate creditors make up a heterogeneous group, as a range of different creditors somehow connected with the company can be identified: private parties, including consumers and employees, suppliers, legal persons, victims of the company's wrongful conduct. One can further distinguish voluntary from involuntary creditors, as well as drawing a line between sophisticated or secured creditors (able to secure surety or other collateral agreements by virtue of substantial bargaining power) and weaker or unsophisticated private parties or small business creditors who are not in a position to obtain

¹⁵¹ 147.

¹⁵² 148.

¹⁵³ 148.

¹⁵⁴ 149-150.

¹⁵⁵ 147.

collateral or security. It is often, probably correctly, stated that – barring protection against fraud – sophisticated creditors do not need statutory protection: essentially only default protection mechanisms which can be negated should be supplied.¹⁵⁶ As for involuntary (delictual) creditors, it could well be that this should be a separate legal project, independent from corporate law, as an undifferentiated approach may result in less efficiency for contract creditors.¹⁵⁷ Corporate creditors should quite likely not be afforded a single, unified set of protections.¹⁵⁸ No doubt many distinct areas of the law provide for creditor protection. Where a particular class of creditor is concerned – e.g. delictual creditor, pensioner, employee, and the like – and protection is warranted, it could indeed be beneficial if this treatment comes from the discrete bodies of law concerned with these stakeholders – i.e. the law of delict, pension law or labour law.¹⁵⁹ In this way the generalised creditor protection provided for in company law can profitably be tailored to that species of creditors it is arguably meant for: competent contracting creditors.¹⁶⁰

A functional or contextual approach to creditor protection seems to be called for: in the particular context – e.g. distributions, the South African legal system, etc. – the various risks need to be discerned, so that an appropriate level of creditor protection for each respective stakeholder can be devised. This also needs to be remembered when comparing creditor protection schemes in different jurisdictions. Not every legal system will employ the same underlying philosophy of creditor protection.

At every turn it is also worth recalling that limited liability is the reason for the requirement of solvency and liquidity. The near-universal regime of capital maintenance was the result of the loss by creditors of the right to hold equity holders personally liable on business debts:¹⁶¹ and so solvency and liquidity naturally serve a similar function. The particular pervasive worry under discussion in this thesis is that of asset dilution: the reduction of the size of the corporate asset pool available to creditors by the making of distributions to shareholders

¹⁵⁶ Kraakman "Concluding remarks on creditor protection." *European Business Organization Law Review* 7, no. 01 (2006): 465-471 467.

¹⁵⁷ 469; also see Mulbert "A Synthetic View of Different Concepts of Creditor Protection, or: A High Level Framework for Corporate Creditor Protection." *European Business Organization Law Review* 7, no. 1 (2006): 357-408, 391.

¹⁵⁸ Kraakman "Concluding remarks on creditor protection." *European Business Organization Law Review* 7, no. 01 (2006): 465-471 470.

¹⁵⁹ 491.

¹⁶⁰ 471.

¹⁶¹ 466.

(which often occurs in the region of insolvency).¹⁶² Shareholders and directors have a compelling incentive to remove value from creditors in the region of insolvency and to make inefficient decisions.¹⁶³ It should be borne in mind that, all other things being equal, any distribution will raise a corporation's likelihood of default, even though the increase will often be negligible. Any distribution from company assets to shareholders necessarily shifts some of the risk of the future business activities from the shareholders to the creditors. Fundamentally: If funds are allowed to flow from the company to shareholders without assurances that all creditors will be paid in due course, a limit to these distributions must be devised. Abstractly, assets are open to distribution if it can be expected with sufficient certainty that the company will not need these assets to satisfy its debts.

However, at the same time, it should also be remembered that the making of distributions naturally attracts investors. Accordingly, the rules regulating limitations on distributions must balance these divergent interests in view of economic efficiency considerations.¹⁶⁴ Essentially, the gains enjoyed by creditors in increasing the level of creditor protection should outweigh the efficiency losses suffered by shareholders and *vice versa*.¹⁶⁵

What is more, contrary to what is often supposed, corporate creditors do not face basically different risks as compared with creditors of natural persons; limited liability likely does not create *unique* risks but rather only massively increases existing risks (with the same character).¹⁶⁶ Neither companies nor natural persons have unlimited funds. Unlimited liability does not entirely eliminate opportunistic behaviour. Specifically concerning *ex post* devaluation of claims owing to opportunistic behaviour, corporate- and natural person-debtors differ in quantitative, not qualitative, terms.¹⁶⁷ There is no distinction in kind, merely in degree. Consider the case of a natural person near insolvency who transfers his assets to his spouse with a view to preventing creditors from realising their claims against him.¹⁶⁸ It is only that companies as debtors differ to the extent that they are radically more inclined to act opportunistically, as directors and shareholders are not directly liable towards the creditors.¹⁶⁹

¹⁶² 468.

¹⁶³ 468.

¹⁶⁴ Mulbert "A Synthetic View of Different Concepts of Creditor Protection, or: A High Level Framework for Corporate Creditor Protection." *European Business Organization Law Review* 7, no. 1 (2006): 357-408, 371.

¹⁶⁵ 371.

¹⁶⁶ 369.

¹⁶⁷ 370.

¹⁶⁸ 370.

¹⁶⁹ 370.

Moving away from the creditor protection philosophies and returning once more to some more concrete evaluative points concerning solvency and liquidity specifically: it has been submitted that the “internationally acknowledged bottom-line test for permissible distributions is a two-part distribution test”.¹⁷⁰ Hanks’s criticism of the solvency element cannot simply be taken at face value. The solvency element might well be desirable – even necessary – insofar as it acts as a reliable shielding device in respect of *long-term* obligations.¹⁷¹ The main reason seems to be that the liquidity component does not “ask whether ‘existing’ assets cover ‘existing’ obligations but confers upon directors the discretion to assume that ‘existing’, legally accrued liabilities shall be covered by future assets and profits the accrual of which depends on future operations of the company”.¹⁷²

No dependable benchmark seems to be in the offing in terms whereof long-term liabilities will be matched in future profits.¹⁷³ Exclusively opting for a liquidity test might result in a situation where traditional solvency (accrued assets covering accrued liabilities) need not be satisfied and where no consequential statement can be made regarding the future solvency of the company as regards long-term obligations.¹⁷⁴

In this sense, then, an argument seems to emerge to the effect that the solvency element serves an important function and so should not be jettisoned: it has to ensure a minimum protection of sorts for long-term obligations. It could well work against the interests of several stakeholders if the solvency element is abandoned – certainly amongst them, the present and former workforce as regards pension liabilities, as well as the general public, taking into account, for instance, provisions catering to the environment.¹⁷⁵

Hanks complained that the solvency test assumes that all liabilities are currently due. But, it is also true that where liabilities are in fact presently due and payable, it is not invariably prudent to regard those debts as covered by projected or future profits. Furthermore, doing

¹⁷⁰ 389.

¹⁷¹ Schön "Balance Sheet Tests or Solvency Tests—or Both?." *European Business Organization Law Review* 7, no. 1 (2006): 181-198, 190.

¹⁷² 190.

¹⁷³ 190.

¹⁷⁴ 190.

¹⁷⁵ 193.

away with the solvency test would leave directors with less guidance in practice.¹⁷⁶ This line of reasoning is taken seriously in many places: support for it can be found in the Netherlands, the US, and in New Zealand.¹⁷⁷ Therefore, it certainly appears that there are sound reasons for requiring both a solvency and a liquidity element.

3.3 Pragmatic Issues

In order properly to facilitate economic growth and enable smoothly functioning commercial enterprise, corporate law has to be certain, clear and accessible. The 1973 Act was categorically complicated, opaque and anomalous; for it to be barely functional countless amendments had to be effected. A cohesive and comprehensible philosophy or inner logic was compromised in the utilisation of this untidy, piecemeal reform process. But now South Africa has a new Act. The aim in the drafting process was always to make the 2008 Act simpler, easier, more accessible, and more efficient. It was always the aim in the drafting of the 2008 Act to create a more investor-friendly company law system, to make the system more flexible, modern, transparent, and predictable; and to harmonise South African company law with best practice internationally.¹⁷⁸

It is no secret that these lofty and vague aims have not really been actualised.¹⁷⁹ Similar problems as with the 1973 Act, it is becoming clear, beleaguer the 2008 Act. Instead of incremental amendments, a completely new Act was introduced; but a ‘clean slate’ approach was not followed.¹⁸⁰ Where old legal provisions satisfy the objectives of the new corporate law regime and embody the objects of constitutionalism, it is supposed to subsist as part of the new company law regime. Cassim maintains that this “conservative middle-path approach...causes difficulties and conflict throughout the Act in blending the old with the radically new philosophical underpinnings of modern company law”.¹⁸¹ The legislature fervently adopted a plain-language approach in the drafting of the 2008 Act; but this has often led to significant ambiguity and uncertainty.

¹⁷⁶ 196.

¹⁷⁷ 193.

¹⁷⁸ See the Memorandum on the Objects of the Companies Act, 2008 B 61D – 2008 in par 1 at 186.

¹⁷⁹ Cassim “The Companies Act 2008: An Overview of a Few of its Core Provisions” (2010) 22 SA Merc LJ 157-175.

¹⁸⁰ See the Memorandum on the Objects of the Companies Act, 2008 par 1.2.5 at 187.

¹⁸¹ Cassim “The Companies Act 2008” (2010) 159.

To recapitulate, one of the aims of this thesis is to provide a workable interpretation of the solvency and liquidity requirements and the distribution provisions. This is done on the basis of the framework sketched in Chapter 2, as well as the relevant pragmatic aids put forward in this section. It is later pointed out where substantive revision is necessary, as the current language simply cannot reasonably bear a functioning, logical and efficient content.

One's first port of call naturally has to be the language of the 2008 Act. Section 7 spells out the purposes of the Act. Not surprisingly, these are quite vague. The encouragement of entrepreneurship, enterprise efficiency, the promotion of investment, the productive use of capital, the spreading of economic risk, inter alia, are listed. More interestingly, section 5(1) – read with section 7 – requires that the 2008 Act has to be interpreted and applied in such a way as to give effect to the purposes listed in section 7.

It is difficult to conceive how a court should go about giving effect to such wide objectives in a given case. Cassim contends that a clear and unambiguous legislative provision must be applied – if it bears on the facts in question – even if it is inconvenient or absurd.¹⁸² Which is to say, presumably: section 5(1), read with section 7, must be applied, notwithstanding the broad language in which the purposes are couched. But, by the same token, he believes the purposes set out in section 7 are prefatory; and that this is how they should be treated.¹⁸³ Most probably, then, Cassim reckons the direct injunction of section 5(1) should not be taken too seriously.

Moreover, section 5(2) provides that a court 'may' consider foreign company law, insofar as it is appropriate, when a court interprets or applies the Act. It is probably true that US law should now play an important part in this regard, considering the significant influence of the Model Act. But English company law – in particular the common law on companies (no 'clean slate' approach is advocated) – should continue to exert some influence. Canadian and Australian law, as well as the corporate law of New Zealand, might also be relevant, because of some borrowed provisions from those jurisdictions.

It is unavoidable that sections 5(1) and 5(2) have to be played down somewhat. The legal content – the legislature's legal assertion – is clear enough, however. These provisions might

¹⁸² 159.

¹⁸³ 159.

at first blush appear to provide important legal and jurisprudential backing to the use of certain pragmatic tools in the interpretation of the Act. If a certain provision of the Act is opaque, and can convincingly be related to a pertinent purpose mentioned in section 7, such an interpretation could attain some legitimacy. Likewise, especially where the unclear provision in question has been borrowed from another jurisdiction, an interpretation made through the lens of that jurisdiction, rendering the provision more logical and efficient, could acquire more legitimacy via section 5(2). The hope would be that the purposes can profitably act as legally sanctioned tie-breakers of sorts. One is hopefully made aware of the prevailing rationales behind the Act, and this could well be of use in the face of an interpretative puzzle. Theoretically, this sounds appealing, but it is difficult to imagine a situation in which it would actually play out in this way (particularly with reference to section 5(1)). The listed purposes are simply too vague; they often seem to be open-ended, repetitive and fanciful ambitions or values, rather than concretely realisable purposes. It would not easily make sense to read highly technical company law provisions – like those of corporate finance law – in the light of these broad values.

There is, moreover, the possibility of conflicts between the purposes. The 2008 Act must be interpreted in a way that enforces the purposes of section 7. But what if one purpose is at odds with another in a particular case? For instance, it would not be hard to imagine an instance where ‘the promotion of the compliance with the Bill of Rights’ clashes with ‘enterprise efficiency’. Tension between, for example, enforcing employment rights and giving effect to efficiency is not difficult to envision. The fear would be that, contrary to the injunction of section 5(1), the judiciary would first decide the matter, and *ex post facto*, justify its decision with reference to one or more of the listed purposes. This would not be highly unusual, as it frequently happens in numerous legal areas. In very many matters of legal interpretation, an intuitive sense (or bias) can sway an interpreter a certain way, and certain parts of the legal materials (to the exclusion of other parts) are relied upon to substantiate this preconceived inclination. Descriptively speaking, it will be useful to see how the courts have dealt with the issue, now that the 2008 Act is operational, and to see whether (and to what extent) this phenomenon presents itself.

In *Nedbank Ltd v Bestvest 153 (Pty) Ltd; Essa and another v Bestvest 153 (Pty) Ltd and another (Companies and Intellectual Property Commission and another intervening)*, which concerned an application for business rescue, the court refers to the section 7 purposes of the

2008 Act, as well as the injunction in section 5, stating that it is not “particularly innovative”.¹⁸⁴ Nevertheless, referring to the purposes in section 7, the court is of the view that a “fresh approach” to company law is introduced insofar as the foundational values of the Constitution have to be promoted, and the spirit and purposes of the Act have to be honoured.¹⁸⁵ Mention is also made in this context of section 39(2) of the Constitution to the effect that all law must be interpreted through the prism of the Bill of Rights.¹⁸⁶ In particular, a parallel is drawn between section 5(1) of the 2008 Act and section 39(2) of the Constitution on the one hand; and section 5(2) of the 2008 Act is compared to section 39(1)(c) of the Constitution, on the other.

The latter pair represents the optional reliance on foreign law, whereas the former pair deals with the compulsory reliance on a set of values or purposes – the purposes of section 7, and the values of the Bill of Rights, respectively. The mandatory pair is most problematic. It contains a definite injunction with unclear content. What if the values or purposes conflict – which receives precedence? Despite the court’s reference to the purposes of the 2008 Act, sections 5 and 7 doubtless did not play anything like a decisive role in the outcome of the case. The case naturally turned on the specific provisions involving business rescue. The most that could be said is that the court’s analysis of section 5 and 7 led to a purposive interpretation of the business rescue provisions – and not that any specific purpose in section 7 proved decisive. Even section 7(k) – which deals with business rescue – was not strictly ‘given effect’, as the application was denied, and so, strictly, an efficient rescue was not expedited (even if the test for allowing these types of applications put forward in this case was fairly wide.) This is not to criticise the court’s judgment, but only to illustrate the awkward interpretative scheme under discussion. The court certainly makes a point of saying that the 2008 Act will require novel thinking in several areas and it can no doubt be argued that a decision of this nature could well (eventually) spur additional, more radical changes in the Act, deriving from a more nuanced and holistic view of interpretation. The necessity for purposive interpretation, the mandate to read the Act commensurately with constitutional values, and the requirement to understand the provisions of the 2008 Act contextually, in light of the totality of the Act, is spelled out in no uncertain terms.¹⁸⁷

¹⁸⁴ [2012] 4 All SA 103 (WCC).

¹⁸⁵ Paragraph 20.

¹⁸⁶ Paragraph 22. Constitution of the Republic of South Africa, 1996.

¹⁸⁷ Paragraphs 21-25.

The next case in which sections 5 and 7 also came up is *Ex parte Gore NO and Others NNO (in their capacities as the liquidators of 41 companies comprising King Financial Holdings Ltd (in liquidation) and its subsidiaries)*, which was the first case in which the new statutory remedy of piercing the corporate veil was considered.¹⁸⁸ Here the legislation's interpretative scheme comes up much later in the judgment.¹⁸⁹ The court nowhere elaborates on which specific purpose(s) it is giving effect to, but instead merely adds the reference to section 7 in order to bolster an argument that has already been made on different grounds. By the time the court considered sections 5 and 7, it seemed already to have decided to pierce the corporate veil on the basis of its understanding of the facts and the relevant legal principles. It appears to be justifying throughout *why* it can do so: the court focused on the broad wording of the provision and concludes that the old test for piercing the corporate veil has not been materially changed.¹⁹⁰ The tenor of the decision is always gesturing towards a wider, more liberal application of the test. But the *ratio* is still encompassed by the considerations underpinning the established test for piercing the corporate veil. That is, the court found that a group of companies had been used by their controllers in a manner which constituted unconscionable conduct as required by the provision. The court then (tentatively) proceeds to expand on the parameters of a potentially wider approach to piercing the corporate veil, given the wider wording in the 2008 Act. However, it is clear that the reference to 'purposes' is something of an afterthought, rather than being a constitutive element in the court's reasoning.

A similarly perfunctory reference appears in *Peninsula Eye Clinic (Pty) Ltd v Newlands Surgical Clinic and others*,¹⁹¹ which involved the reinstatement of a company's registration in terms of section 82(4) of the 2008 Act, and specifically whether the reinstatement was of retrospective effect. The court finds that the practical purpose of reinstatement would be severely diminished if it did not have the effect of retrospectively restoring the corporation's personality (and reinvesting it with title to its property).¹⁹² To add weight to this commonsensical claim, the court states that the section 7 purposes would not be furthered if the effect was not retroactive. But the court does not cite any particular purpose in this regard. The court sees itself as taking heed of section 5's injunction. In a footnote, the court submits

¹⁸⁸ [2013] 2 All SA 437 (WCC). Section 20(9) is the statutory provision dealing with the piercing of the corporate veil.

¹⁸⁹ That is, in paragraph 32.

¹⁹⁰ Paragraph 32.

¹⁹¹ [2014] 1 All SA 592 (WCC).

¹⁹² Paragraph 44.

that the emphasis in section 7 is on “simplicity, flexibility, efficiency and predictability”.¹⁹³ It is unclear why these should be regarded as the most important purposes. It is also not clear whether these purposes exactly served a tie-breaker function. Rather, the court saw these purposes as congenial to its general course of reasoning.

The *DH Brothers Industries (Pty) Limited Gribnitz NO and others* case was decided shortly after the previous case and dealt with issues surrounding business rescue.¹⁹⁴ The court’s point of departure in this case was to turn to sections 5 and 7 of the Act. In this case the court was ultimately to set aside a resolution placing a company under business rescue. Instead of using one of the purposes in section 7 to bolster an argument it wants to make, the court essentially had to give practical content to section 7(k) in order to counter a contrary argument. In doing so, the court had also to consider some of the other mentioned purposes of section 7. The court says that section 7 does not back the acceptance of a business rescue plan at all costs.¹⁹⁵ The “rights and interests of all stakeholders” have to be balanced; and creditors certainly fall under “stakeholders”, according to the court.¹⁹⁶ Part of the reason creditors’ rights have to be taken seriously in the business rescue process is that, were it not so, other section 7 purposes would be violated, argues the court. In this regard the court could appeal to vague purposes, such as providing a predictable environment for the efficient regulation of companies, promoting the development of the economy, promoting investment in the South African markets, creating optimum conditions for investment, and so on – the implication being that creditor protection is an important goal of the Act.¹⁹⁷

The most recent case in which section 7 played a role is *Boschpoort Ondernemings (Pty) Ltd v Absa Bank Ltd*.¹⁹⁸ In this case the court, *inter alia*, had to determine the test for solvency in liquidation proceedings. The court argues that a company’s *commercial*, not mere factual, insolvency constitutes a ground which justifies an order for that company’s liquidation. Factual insolvency is simply where a company’s liabilities exceed its assets; commercial insolvency is where a company cannot pay its debts even though its assets exceed its liabilities.¹⁹⁹ The court states that this position has stood the test of time, and points to several

¹⁹³ Footnote 22.

¹⁹⁴ [2013] JOL 31017 (KZP).

¹⁹⁵ Paragraph 54.

¹⁹⁶ Paragraph 54.

¹⁹⁷ Paragraph 54.

¹⁹⁸ [2014] 1 All SA 507 (SCA).

¹⁹⁹ Paragraph 16.

logical reasons why this is so.²⁰⁰ Significantly, the court then goes on to say that, were the converse position to prevail, section 7(1) would be undermined. That is, if the test for solvency were factual, a predictable and effective legal environment for the adjudication of the liquidation of companies would be undermined.²⁰¹ The court seems to paint section 7(1) as being quite instrumental to its reasoning. In truth, the same conclusion could be reached by reference only to the other logical reasons furnished by the court.²⁰² It cannot be denied, looking at the extremely vague, open-ended content of section 7(1), that the section could very well be used as justification for a great variety of incongruous assertions. That is not to say that the court's reasoning is unsound. The converse of the court's ultimate conclusion might indeed hamper predictability and efficiency in the regulation of companies. It is just that section 7(1) is not decisive in the court's reasoning.²⁰³

Mention should also be made of section 158, which provides for remedies to promote the purposes of the Act. Courts are required to develop the common law so as to improve the realisation of the rights contained in the Act. This is, once again, indicative of the middle-path approach, in which old law is preserved, to the extent that it is consistent with the goals and provisions of the 2008 Act and the Constitution of the Republic of South Africa (henceforth 'the Constitution').²⁰⁴ The content of the common law appears to be uncertain now. But anything inconsistent with the law ushered in by the 2008 Act clearly cannot stand. Section 158(b)(i) requires that the Commission, the Panel, the Tribunal or a court "must promote the spirit, purpose and objects" of the Act; section 158(b)(ii) says that "if any

²⁰⁰ Paragraph 17.

²⁰¹ Paragraph 17.

²⁰² See paragraph 17.

²⁰³ Other cases in which section 7 featured include: *Oakdene Square Properties (Pty) Ltd and others v Farm Bothasfontein (Kyalami) (Pty) Ltd and others*; *Farm Bothasfontein (Kyalami) (Pty) Ltd v Kyalami Events and Exhibitions (Pty) Ltd and others* [2012] 2 All SA 433 (GSJ) paragraph 12 footnote 17; *Commissioner SARS v Beginsel* 2013 (1) SA 307 (WCC) paragraph 1, 22; *Zoneska Investments (Pty) Ltd t/a Bonatla Properties (Pty) Ltd v Midnight Storm Investments 386 Ltd (Registration No: 2007/019270/06) and another (Grayhaven Riches 9 Ltd and others as Interested Parties; First Rand Bank Limited as Intervening Creditor)* [2012] 4 ALL SA 590 (WCC) paragraph 31; *Employees of Solar Spectrum Trading 83 (Pty) Limited v AFGRI Operations Limited and Another, In Re; AFGRI Operations Limited v Solar Spectrum Trading 83 (Pty) Ltd* (6418/2011, 18624/2011, 66226/2011, 666226/2011, 66226A/11) [2012] ZAGPPHC 359 paragraph 9; *Southern Palace Investments 262 (Pty) Ltd v Midnight Storm Investments 386 Ltd* 2012 (2) SA 423 (WCC) paragraph 1; *Cape Point Vineyards (Pty) Ltd v Pinnacle Point Group Ltd and Another (Advantage Projects Managers (Pty) Ltd Intervening)* 2011 (5) SA 600 (WCC); [2013] JOL 30076 (WCC) paragraph 6; *Van Niekerk v Seriso* 321 CC and Another (952/11, 23929/11) [2012] ZAWCHC. 63 paragraph 20; *Van Staden v Angel Ozone Products CC (in liquidation) and others* 2013 (4) SA 630 (GNP) paragraph 31; *Blue Star Holdings (Pty) Ltd v West Coast Oyster Growers CC* 2013 (6) SA 540 (WCC) paragraph 31; *African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd and others* [2013] 4 ALL SA 432 (GNP) paragraph 23; *Mouritzen v Greystones Enterprises (Pty) Ltd and another* 2012 3 ALL SA 343 (KZD) paragraph 15.

²⁰⁴ Constitution of the Republic of South Africa, 1996.

provision of this Act...read in its context, can be reasonably construed to have more than one meaning” the court/Commission/Panel/Tribunal “must prefer the meaning that best promotes the spirit and purpose of this Act”. This provision is naturally related to the listed purposes in section 7 but also goes beyond it. A strikingly similar provision is found in the Constitution.²⁰⁵ Given the vague nature of ‘spirit and purpose’, this type of provision is not without problems. Like the provisions just discussed, it is unlikely to have any real utility or serve a meaningful tie-breaker function.²⁰⁶

A final remark which ties this section with the preceding chapter, is apposite. I have already mentioned the emphasis in the drafting process on plain or ordinary language.²⁰⁷ Though the extent to which the drafters succeeded in this endeavour is debatable, the object was to word the Act in simple, clear and accessible terms.²⁰⁸ Primarily, then, this is how the authoritative lawmakers intended the Act to be construed – in a commonsensical, and predictable manner. It thus seems reasonable to assume that the legal content of the 2008 Act should be identified in this way. It seems that excessively complex or technical interpretations should in the main be eschewed. However, this model all but breaks down where the legislature’s very coherence and good sense is open to question. A measure of creativity will be necessitated, as inventive interpretations are unavoidable. In such cases, it is just that careful justifications have to be proffered.

3.4 The 2008 Act: The Components of the Solvency and Liquidity Test

The stage is now set to consider the various facets of the solvency and liquidity test. Below I look at the two distinct components of the test, I reflect on the assets and liabilities that are to be considered in an application of the test, I evaluate the position of preference shareholders,

²⁰⁵ See section 39(2) of the Constitution of the Republic of South Africa, 1996.

²⁰⁶ See *Zoneska Investments (Pty) Ltd t/a Bonatla Properties (Pty) Ltd v Midnight Storm Investments 386 Ltd* [2012] 4 All SA 590 (WCC) paragraphs 31-34 where the court utilises section 158 and section 7 in the context of the business rescue provisions of the 2008 Act. It is submitted, however, that the wording of the Act – in particular section 158(b)(iii) – already countenances the court’s general line of inquiry. Far from the ‘fresh’ interpretative provisions of the 2008 Act providing genuinely new grounds, the relevant conclusion, consistent with the argument gleaned from the above cases, is rather derived from the specific wording of the Act. See further *Count Gotthard SA Pilati v Witfontein Game Farm (Pty) Ltd and others* [2013] 2 All SA 190 (GNP) paragraph 15.1; *Nulandis (Pty) Ltd v Minister of Finance and Others* 10760/12 2013 (5) SA 294 (KZP) paragraph 59.

²⁰⁷ See page 50.

²⁰⁸ See section 6(4)(b) and (5) of the 2008 Act in reference to disclosures, notices, prospectuses and documents; in addition to the pervasive mention and implicit importance of ‘plain language’ in the policy and preparatory documents, this section specifically requires ‘plain language’ where no form has been prescribed for the disclosure, notice, prospectus or document.

and inquire into the time when the test should be considered and satisfied. I also analyse the way in which the test is to be applied. It is admitted that this approach of treating the solvency and liquidity requirement in a compartmentalised way often lends itself to a measure of overlap, as well as anachronism. However, the minutiae of the relevant provisions, in my view, throw up vital thematic talking points which can (and, it is submitted, should) be separately tackled. The hope is ultimately that the language of the provisions coheres, as well as that the underlying philosophical issues fit together appropriately. These points apply for this chapter; but they equally apply to the relationship between solvency and liquidity on the one hand, and the distribution provisions on the other. Hence, overlapping considerations follow as a matter of course, as the Act inextricably links these two areas (i.e. satisfaction of the financial restrictions is required to satisfy the requirements for distributions).

The elements or components of the solvency and liquidity test can be found in section 4 of the 2008 Act. The solvency part is contained in section 4(1)(a) and the liquidity part in section 4(1)(b). Satisfying both elements constitutes necessary and sufficient conditions for passing the test: it is necessary to meet both requirements and this is sufficient for passing the test. As a limitation on distributions, the solvency part means the assets of the corporation should exceed its liabilities after the distribution has been factored in. As a result, distributions can only be made out of net assets. In contradistinction, the liquidity part denotes the capacity of the company to service its debts as they become due.²⁰⁹

The practically significant difference between the capital maintenance test and a solvency test is that the capital maintenance test necessitates a margin over solvency tantamount to the company's share capital. It is the 'guarantee fund' of the company which the shareholders built up which constructs this margin. In that sense, Van der Linde is probably right to claim that satisfying the capital maintenance test entails the satisfaction of a simple solvency test (not the collective solvency and liquidity requirement).²¹⁰ But, at the same time,

²⁰⁹ To keep things simple and clear, I will talk only of the terms 'solvency' and 'liquidity', as this is the chosen terminology in the 2008 Act. Intermittent reference is made to other legal systems, and since the terminology differs somewhat, it must be borne in mind that what in South Africa is dubbed the solvency part is often referred to as bankruptcy solvency (determined by means of a balance sheet test); and the liquidity test in South Africa is generally co-extensive with what is elsewhere called 'equity solvency', 'equity insolvency test' or simply 'equity test'. See Van der Linde "The solvency and liquidity approach in the Companies Act 2008" (2009) 2 *TSAR* 224, 225.

²¹⁰ See Van der Linde "The solvency and liquidity approach in the Companies Act 2008" (2009) 2 *TSAR* 224, 226.

particularising the capital maintenance test to the South African context, that remark likely no longer holds water. A lot can turn on the meaning ascribed to capital. The narrow interpretation afforded by the South African courts as to what precisely could and could not be paid back to shareholders, as well as the fact that capital was not immunised from business risks, could very well mean that a simple solvency test is not without more satisfied in the application of capital maintenance. At any rate, what is certain is that meeting the capital maintenance requirement does not entail compliance with the *liquidity* test; there is no conceptually necessary connection between the two. For that reason, in order properly to safeguard the interests of creditors, legal systems with capital maintenance regimes often supplement capital maintenance with a liquidity test.²¹¹

As regards the liquidity test, South Africa has opted, not for the balance sheet test based on current assets and current liabilities, but a cash flow analysis. A cash flow prediction is identified by the phrasing “that the company will be able to pay its debts as they become due in the ordinary course of business...”.²¹² On this approach, in addition to current assets, credit extended to the company, as well as future income is taken into account; likewise, not merely current liabilities, but also prospective liabilities are considered.²¹³ It follows that the choice of this approach could influence the valuation of contingent liabilities, as future assets and liabilities are accounted for by the cash flow analysis. This approach, however, does not reflect another sea change in company law; it was also the line taken by the 1973 Act after the 1999 amendments.

Van der Linde claims that distinct theoretical justifications underlie the solvency element on the one hand and the liquidity element on the other.²¹⁴ On her view, the solvency requirement asserts beforehand the final precedence of creditor interests over that of shareholders by preventing the corporation from favouring the shareholders through a partial liquidation.²¹⁵ On the other hand, the liquidity component is said to legitimate two things: the foundational expectation of creditors to be paid on time, and the supposed representation a company makes upon the incurrence of a debt that it reasonably expects to be capable of paying when

²¹¹ Cox and Hazen *Corporations* (2003) 562.

²¹² Section 4(1)(b) of the 2008 Act.

²¹³ Van der Linde “The solvency and liquidity approach” (2009) 226.

²¹⁴ 226.

²¹⁵ 226.

the debt is due.²¹⁶ It would be unfair for a company to compromise its liquidity through the making of distributions to its shareholders where it made a tacit representation of liquidity at the outset.²¹⁷

While not without merit, the distinction Van der Linde draws in this regard is perhaps somewhat pedantic. The pervasive object or justification of capital maintenance, solvency, and liquidity is arguably quite unitary. These concepts principally aim at safeguarding the interests of creditors: ensuring that they are paid back in full and on time. Both the solvency and liquidity requirement speak to the ultimate priority that creditors enjoy over shareholders. One can, for instance, also maintain that the company makes an implicit representation, not only that it expects to pay when the debt is due, but also that it will not privilege the shareholders over the creditors through a partial liquidation. It is more a matter of whether the obligation in question is a long-term one or not. Even inquiring as to which test is stricter proves unhelpful. It will hinge on the specified mechanics of applying each in their particular context.²¹⁸ It remains, then, to study the unique mechanics of the respective elements, as enshrined in the 2008 Act.

A further conceptual point is in order. It has been stated that the primary focus of this thesis is distributions. It is submitted that a self-contained analysis is possible, even though a measure of overlap, especially with acquisitions by a company of its own shares and acquisitions by a subsidiary in its holding company, is invariably discernible. Unique considerations certainly underpin each of these broad themes. That is in spite of the fact that the aforesaid acquisitions legally do in fact constitute ‘distributions’ in terms of the Act – under section 1(a)(iii)(aa) and (bb) – and need to comply with section 46 (the principal distributions provision, governing the requirements for making a distribution) – 48(2)(a) of the Act explicitly requires this. Economically speaking, the effect on the company’s financial position of a payment to shareholders is identical, regardless of whether it is a dividend paid to all shareholders or a *pro rata* acquisition of shares by the company.²¹⁹ Notwithstanding these points, an acquisition is not the same as a distribution. Every distribution is not also an acquisition. But every acquisition *entails* the making of a distribution. So it is just that some

²¹⁶ 226.

²¹⁷ 226. Of course, it should be borne in mind that this could be said to be the basis for the law, yet there is no actual requirement to make the representation in question.

²¹⁸ Schön "Balance Sheet Tests or Solvency Tests—or Both?," *European Business Organization Law Review* 7, no. 1 (2006): 181-198, 189.

²¹⁹ Hanks "The new legal capital regime in South Africa" (2010) *AJ* 143.

distributions (as defined in section 1 in the 2008 Act) are distributions pursuant to the acquisitions of shares.

The link between the distribution provisions and the solvency and liquidity requirement is provided at various places in section 46.²²⁰ The solvency and liquidity test is set out in full in section 4 and reads as follows:

‘(4) Solvency and liquidity test

(1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time—

(a) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued; and

(b) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of—

- (i) 12 months after the date on which the test is considered; or
- (ii) in the case of a distribution contemplated in paragraph (a) of the definition of ‘distribution’ in section 1, 12 months following that distribution.

(2) For the purposes contemplated in subsection (1)—

(a) any financial information to be considered concerning the company must be based on—

- (i) accounting records that satisfy the requirements of section 28; and
- (ii) financial statements that satisfy the requirements of section 29;

(b) subject to paragraph (c), the board or any other person applying the solvency and liquidity test to a company—

- (i) must consider a fair valuation of the company’s assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective whether arising as a result of the proposed distribution, or otherwise; and
- (ii) may consider any other valuation of the company’s assets and liabilities that is reasonable in the circumstances; and

(c) unless the Memorandum of Incorporation of the company provides otherwise, when applying the test in respect of a distribution contemplated in paragraph (a) of the definition of “distribution” in section 1, a person is not to include as a liability any amount that would be required, if the company

²²⁰ Sections 46(1)(b), and 46(1)(c) chiefly invoke the solvency and liquidity requirement. The rest of the subsections of section 46 essentially structure the practical considerations going into a consistent and proper application of the test.

were to be liquidated at the time of the distribution, to satisfy the preferential rights upon liquidation of shareholders whose preferential rights upon liquidation are superior to the preferential rights upon liquidation of those receiving the distribution.’

The test will apply to sections 44 (financial assistance for subscription of securities), 45 (loans or other financial assistance to directors), 46²²¹ (the requirements for making a distribution), 48 (company or subsidiary acquiring company shares), and 113 (amalgamations or mergers) of the 2008 Act.²²²

3.4.1 The Solvency Component

The Companies Amendment Act 3 of 2011 has improved the 2008 Act in certain respects. Certainly the solvency element, as enshrined in the 2008 Act, has benefited from this amendment endeavour. Before its enactment, the position was that the solvency part of the test was passed “at a particular time” if, “considering all reasonably foreseeable financial circumstances of the company at the time the assets of the company or, if the company is a member of a group of companies, the consolidated assets of the company, as fairly valued, equal or exceed the liabilities of the company or, if the company is a member of a group of companies, the consolidated liabilities of the company, as fairly valued”. The reference to group assets and liabilities served only to confuse. Plainly, if the company is not a member of a group, its assets must simply equal or exceed its liabilities (where both are fairly valued). And if it is part of a group, the consolidated assets of the company must equal or exceed the consolidated liabilities of the company (where both are fairly valued).

The term ‘consolidated’ was used for companies that formed part of groups, but not for a single company. This was a curious choice. Following the plain language approach – the way the legislature seemingly wanted the Act to be read, which thus should get one closer to the full legal content – ‘consolidated’ was probably interchangeable with a term like ‘aggregate’ (which also cropped up in previous versions), which is loosely to be interpreted as ‘taken together’ or ‘as a whole’. But naturally this is implied; it surely must also apply to the case of a single company. And so the term is redundant. Singling the term ‘consolidated’ out only for membership to a group of companies might also suggest that the legislature wanted to include

²²¹ See chapter 4.

²²² See 3.1 and 3.4.

the assets and liabilities of all the companies in the group. The legislature's full assertion seems to militate against this construal, however. Additionally, this could mean that an insolvent company could pass the solvency test by invoking the assets of other companies in its group, patently to the detriment of corporate creditors.²²³ The effect would be that the assets of the group (and thus also of holding companies and co-subsiaries) would have to be taken into account each time a company in the group makes a distribution.²²⁴

It is encouraging to see the amendment address these concerns. The simpler formulation seems to steer clear of these concerns. The aim of the solvency test – together with the liquidity test – is to protect creditors: this is done if every individual company by itself is required to pass the test, whether it forms part of a group or not.²²⁵ Certainly, a different analysis will be called for in case a subsidiary purchases shares in its holding company. In this event, the value of the subsidiary should not be counted twice in determining the value of its assets.

It seems this distinction between individual companies and companies in a group was likely tailored to prevent evasion of the financial restrictions. Paradoxically, as explained, the exact opposite could ensue, where the aggregate assets and liabilities of the group are considered and an individual insolvent company in a group could pass the test by relying on the assets of other companies in the group – the financial restrictions are evaded and creditors could suffer. If this were to be true, it could create the extremely difficult situation where, ostensibly, the legislature intends something different from the semantic meaning of the words it employed. The legislature intended to prevent evasion (by hypothesis) – and this certainly would not seem a fanciful reading – but the semantic meaning of the provision entailed the opposite. I have argued that the job of the interpreter is to gauge the full legal assertion enacted by the law (not the semantic meaning, nor simply the intent). I do not purport to have an easy solution to this type of conundrum; in each particular case one simply

²²³ Jooste “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” (2009) 126 *SALJ* 627, 641.

²²⁴ The point also applies if one has regard to the technical meaning ascribed to the term in accountancy. In accounting, consolidation is a term of art meaning that the shares held in another company would not merely be included at their value but that the assets and liabilities of the entities will, for accounting purposes, be evaluated together. However, it would be *legally* unacceptable because they are still distinct entities and so creditors may be over- or under-protected as a result.

²²⁵ It is interesting to note that, in the four drafts of the Companies Bill, it is the first draft which has now been returned to by means of the recent amendment; the initial unadorned version turns out actually to be the best, and the legislature ultimately realised this. See Jooste “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” (2009) 126 *SALJ* 627, 641-2.

has to attempt to reasonably discern the assertion of the legislature – understood as the entire linguistically based content, including intent, pragmatic considerations, and semantic meaning. Fortunately, in this case, the amendment has obviated this concern.

Van der Linde believes the regulation of distributions in the group context should be confined to cases where a subsidiary makes a distribution to the shareholders of its parent company.²²⁶ In this event, it must be clarified whether the test should be applied to the subsidiary and the holding company independently, to the subsidiary and the holding company together (as a unit), or to the group as a whole.²²⁷ Van der Linde suggests that the test should be met by both the holding company and the subsidiary.²²⁸ Van der Linde also bemoans the fact that the solvency test alone – not in combination with the liquidity test – was regarded as relevant in the group situation.²²⁹ After the amendment, this criticism no longer stands.

In comparison with certain other jurisdictions, Van der Linde deems the South African solvency test to be “relatively lenient and out of step with international standards”.²³⁰ Barring the case where the liquidation preferences of preference shareholders have to be considered, the 2008 Act does not provide for a solvency margin: the threshold is simply that the assets *equal* the liabilities following a distribution; the assets *need not exceed* the liabilities. In view of the discussion above concerning the views of Hanks, it is astounding to see how starkly corporate law scholars can diverge on this issue.²³¹ Hanks would not only balk at the suggestion of a solvency margin, but would even do away with the solvency requirement altogether – and essentially argues that creditor protection is not really the domain of corporate law. As the matter has been dealt with at some length above – and since I chiefly want to offer up an analysis of the Act as it is – I will leave the theoretical-normative debate there.

²²⁶ Van der Linde “The solvency and liquidity approach” (2009) 228.

²²⁷ 228.

²²⁸ 228. See further Bhana “Company law implications of conferring a power on a subsidiary to acquire the shares of its holding company” 2006 *Stell Law Review* 232, 239.

²²⁹ Van der Linde “The solvency and liquidity approach” (2009) 228.

²³⁰ 228-9. The jurisdictions she points to in this regard include California, the United Kingdom, New Zealand, and the American Model Business Corporation Act. Though, it should be noted, regarding the latter two, that she is referring to liquidation preferences of classes of shareholders who have priority over the shareholders to whom the distribution is being made (I consider the issue of preference shareholders below). Apparently, Van der Linde is not excessively displeased with the lack of a solvency margin, as she does not suggest a reform proposal to this effect, see Van der Linde *Aspects* 569.

²³¹ See 3.2 above.

3.4.2 The Liquidity Component

The liquidity test will be passed if, considering all reasonably foreseeable financial circumstances of the company at the time, it appears that the company will be capable of paying its debts as they become due in the ordinary course of business, for a period of twelve months.²³² Further, regarding distributions, in the event that the distribution is in the form of a transfer of money or property, the time period ends twelve months after the date on which the distribution is made.²³³

No time period was specified in section 85(4) of the 1973 Act; whereas now it must appear that the company will remain liquid for a twelve-month period following the distribution. Rule 5.90(g) of the *Listing Requirements of the JSE Limited* in fact does provide for a twelve-month period. There is no universal agreement on the desirability of instituting a fixed time period. As Van der Linde points out, a time limit is imposed in the United Kingdom. But the liquidity component is not anchored to a time limit in California, New Zealand or in the Model Act.²³⁴ This is also true of Australia.²³⁵ Van der Linde reckons the imposition of a time limit is undesirable; she opines that “the ordinary course of business” of each corporation should be the decisive determinant in assessing its liquidity.²³⁶ Jooste, however, was critical of the 1973 Act which failed to provide a fixed time period and welcomes the predictability and certainty of the newly introduced twelve-month period.²³⁷

Van der Linde is sceptical because, as she sees it, the time limit “may disadvantage creditors of companies that have clearly foreseeable longer-term commitments that are not payable within twelve months”.²³⁸ While the twelve-month mark is not devoid of arbitrariness, there is probably little warrant for extending the period further specifically to accommodate these creditors. Longer periods also make calculations more difficult. On Van der Linde’s view, if it really is necessary to implement a time limit to safeguard the interest of creditors, the best way to do so is to create a presumption that the company failed to satisfy the test should it be

²³² Section 4(1)(b) of the 2008 Act, quoted in full above.

²³³ Section 4(1)(b)(ii).

²³⁴ Van der Linde “The solvency and liquidity approach” (2009) 229.

²³⁵ Corporations Act 2001 – Sect 254T (1)(c).

²³⁶ 229.

²³⁷ Jooste “The maintenance of capital and the Companies Bill 2007” (2007) 124 *SALJ* 715.

²³⁸ Van der Linde “The solvency and liquidity approach” (2009) 229.

liquidated within a particular period of time.²³⁹ In relieving the creditors (or the liquidator) of the burden of proof, creditor protection is said to increase: creditors will then not need to prove that the assessment was unwarranted if the corporation is in fact liquidated shortly after the distribution.²⁴⁰ This makes sense, but quite substantial legislative amendments will be required to achieve it; and the need for this is hardly pressing.²⁴¹ Even Van der Linde does admit that the current time limit does provide certainty.²⁴² Probably, no more hairs need splitting on this issue.

It appears that causality does not have a role to play under the liquidity component in the 2008 Act.²⁴³ The test explicitly calls for the position to be determined immediately after a distribution has been made and therefore implicitly discounts the effect of the distribution.²⁴⁴ A distribution will thus be unlawful even where the company is at any rate illiquid and it is not the distribution which causes it. A causation requirement here would focus on the specific effect of a distribution on the corporation's capacity to service its debts; the payment should not render the company unable to pay its debts.²⁴⁵ The test must then be applied by reference to the moment before the distribution is made.²⁴⁶ However, it would seem that there is no need for a causality requirement in this context. To protect creditors, a company should not be allowed to make distributions where it is already illiquid or it is foreseeable that illiquidity would be caused by something else. Once a company is illiquid creditors of course have to rely only on solvency but distributions which increase illiquidity further reduce the likelihood that a company will again become liquid.

Van der Linde tentatively proposes the introduction of a presumption that a company which is liquidated within a specified period of time should be regarded as having failed to comply with the solvency and liquidity requirement and that it should be paired with a causation requirement. Lack of causation should then be allowed as a defence which shareholders can

²³⁹ 229. A two-year period combined with a reverse onus (as described) appears in the Close Corporations Act: payments to members made within two years of the winding-up of a close corporation can be recovered unless the members can establish that the corporation passed the solvency and liquidity test at the time of the payment (section 70(2) of the Close Corporations Act 69 of 1984).

²⁴⁰ 229-230.

²⁴¹ See 4.1 and 4.2.

²⁴² 229.

²⁴³ 230. The position was the same in the 1973 Act.

²⁴⁴ 230.

²⁴⁵ See section 52(1)(c) of the Close Corporations Act 69 of 1984; in California the payment should not seem "likely to result" in inability to pay (see section 501 of the California Corporations Code); see Van der Linde "The solvency and liquidity approach" (2009) 230.

²⁴⁶ 230.

appeal to with a view to escaping liability for the return of distributions they receive.²⁴⁷ However, she ultimately concludes that it is perhaps best that a clean liquidity test prevails: causation and presumptions do not seem necessary. And the twelve-month time limit is quite instructive and would clearly provide helpful guidance.

It should be noted that the 1973 Act also used the phrase “in the ordinary course of business”.²⁴⁸ In a previous version of the 2008 Act, the legislature omitted the word “ordinary”. Provided that there is a sufficient connection to the business of the company, then, ostensibly, debts *not* normally incurred must be considered as well. Jooste deemed it prudent to include all debts.²⁴⁹ There seems to be no warrant for making the test this strict. Ultimately the legislature thought better of it. The resulting formulation is the same as the 1973 Act on this score.

3.5 Which Assets and Liabilities are considered?

The 2008 Act breaks from the old company law regime in this regard: whereas the 1973 Act lacked specific guidelines regarding which assets, liabilities, and debts are to be considered in the determination of a company’s solvency and liquidity (though it did require a fair valuation of assets),²⁵⁰ the 2008 Act is more elaborate. It says that “any financial information” to be taken into account regarding the company must be based on accounting records and financial statements that meet the requirements of sections 28 and 29, respectively.²⁵¹ Section 28(1) requires accounting records to be complete and accurate, whereas section 29(1)(d) requires compliance with financial reporting standards.

As the liquidity component essentially consists in a prediction of the corporation’s cash flow situation concerning the following twelve months, it may be hard solely to rely on recorded financial information in its application.²⁵² In section 4(1) one encounters “reasonably foreseeable financial circumstances” whereas in section 4(2)(a) the phrase “financial information” is used. Quite clearly, these are not interchangeable. Ostensibly “financial information” is a narrower concept. Van der Linde states that the liquidity test should

²⁴⁷ See section 70(2)(c) of the Close Corporations Act.

²⁴⁸ Section 85(4)(a) of the 1973 Act.

²⁴⁹ Jooste “The maintenance of capital and the Companies Bill 2007” (2007) 124 *SALJ* 719.

²⁵⁰ Sections 85(4)(b), 90(2)(b) and 38(2A)(a)(i) of the 1973 Act.

²⁵¹ Section 4(2)(a) of the 2008 Act.

²⁵² Van der Linde “The solvency and liquidity approach” (2009) 230.

therefore be based on financial information in the company's records and statements, in addition to foreseeable circumstances that may influence the company's capacity to service its debts.²⁵³ But the same can be said for the solvency element, as the introductory part of section 4(1) covers 4(1)(a) as well.

Section 4(2)(b)(i) ensures that the solvency and liquidity test is based on a "fair valuation of the company's assets and liabilities." This is compulsory. The optional part is given in section 4(2)(b)(ii), which provides that the board or other person applying the test "may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances". Essentially, the legislature seems to be saying: the board must consider a fair valuation and may consider another reasonable valuation. But jurisprudentially these terms are roughly co-extensive. It is difficult to envision circumstances in which a valuation that is not fair nevertheless amounts to a valuation which is reasonable in the circumstances. Conversely, if there already is a "fair" valuation, it is probably unlikely that another valuation would be "reasonable". The legislature's legal assertions are not really coherent here. But it is probably easy enough to discern what it intended to achieve. The compulsory part shows that the legislature wanted to impose a minimum valuation threshold. The valuation has at least to be "fair". Unfair valuations are not allowed. It seems there is a default or established valuation which can generally be dubbed fair. The discretionary or optional part suggests a recognition on the part of the legislature that an alternative – non-standard – valuation method should also be allowed, so long as it is reasonable. It is, in other words, an attempt to create flexibility. Because what a default ("fair") valuation is supposed to be is not spelled out, the relationship between the two provisions does not really work. However, it is possible that these terms should be read against a different background or pragmatic context. Probably, the mandatory (default) part refers to generally accepted accounting principles (e.g. historical cost accounting); whereas the optional, discretionary part likely connotes current value and appraisal methods. The fair value balance sheet, in accounting terminology, however, in general supplies information about the current value of assets and liabilities, not the historical cost.²⁵⁴ Are lawyers and judges expected to engage in these types of questions? The desirability of indiscriminately inserting technical accounting terms in legislation on company law is open to question. The most that can be said about this confusing issue is that

²⁵³ 230.

²⁵⁴ Haldeman, R.G "Fact, Fiction, and Fair Value Accounting at Enron" (2006) *The CPA Journal*, November, A publication of the New York State Society of CPAs, New York.

the attempt at flexibility here may be laudable, in that, *inter alia*, a valuation method particularly congenial to the type of business can be used. In the Model Act section 6.40(d) achieves something to this effect. It allows reliance either on “financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances”. While itself perhaps not the model of clarity of drafting, it is possible that the Model Act influenced the drafting of this provision in the 2008 Act. As illustrated, the wording of the 2008 Act on this does not achieve the desired effect. Certainly, an amendment is needed.

According to section 4(2)(b)(i), reasonably foreseeable contingent assets and liabilities – including those that will arise from a proposed distribution, or otherwise – must be included at their fair value. In the 1973 Act,²⁵⁵ as well as in earlier versions of the 2008 Act, no clarity was supplied in respect of whether contingent assets and liabilities must be taken into account in determining the solvency and liquidity of the company.²⁵⁶ Strangely, contingent liabilities had to be considered when applying the solvency test of section 38(2A) of the 1973 Act; section 38(2B) explicitly required contingent liabilities to be taken into account.²⁵⁷ Its exclusion from one of the first drafts of the 2008 Act was thus curious. Generally, then, the drafters gradually started dealing with the issue, but to begin with, in a disharmonious way. Therefore, the clarification provided in section 4(2)(b)(i) in the 2008 Act, stating that contingent assets and liabilities indeed have to be taken into account, is welcome -- a measure of uncertainty is eliminated.²⁵⁸ Clearly, section 4(2)(b) now requires contingent assets and liabilities to be considered for the purposes of both the solvency and liquidity test.²⁵⁹ Jooste infers from this that the term “liabilities” used in the solvency component (in section 4(1)(a)) and the term “debts” used in the liquidity component (in section 4(1)(b)) “are used interchangeably”. It is a little strange that the legislature opts for different words in this regard; but I submit that Jooste’s interpretation here is correct.

Van der Linde notes that, in accounting terminology, contingent assets “are assets that the company may acquire in the future”; importantly, contingent assets and liabilities “are not

²⁵⁵ Section 85 of the 1973 Act.

²⁵⁶ Jooste “The maintenance of capital and the Companies Bill 2007” (2007) 124 *SALJ* 715, 720.

²⁵⁷ Section 38 concerns the prohibition on the provision of financial assistance by a company for the acquisition of its shares or the shares of its holding company).

²⁵⁸ Jooste “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” (2009) 126 *SALJ* 627, 643.

²⁵⁹ 643.

required to be reflected in financial statements in terms of international accounting standards and international financial reporting standards, and will also not appear in accounting records”.²⁶⁰ She correctly remarks that “[t]his confirms that ‘financial information’, which may only be based on compliant financial statements and accounting records, must necessarily be a fairly narrow concept...”.²⁶¹ So the application of the solvency and liquidity test entails more than merely consulting statements and records.²⁶²

Essentially, then, on Van der Linde’s view, the inclusion of the concept “contingent” signals (or confirms) that liquidity and solvency does not merely have to be determined with reference to properly compiled financial statements and accounting records. Overall, on my reading of the Act, also considering the structure of the relevant sections, Van der Linde’s interpretation is vindicated. This reading links up well with the concept of “financial circumstances”. It was stated earlier that “financial circumstances” is broader than “financial information”.²⁶³ Van der Linde’s preceding points bear this out. Additionally, it should be borne in mind that “financial circumstances” appears in the all-important introductory, all-encompassing section 4(1). The layout no doubt suggests that “financial information” is but one of the constituent parts making up the broad concept of “financial circumstances”. The latter is the focal point structurally; and the broadness of the concept “contingent” confirms the broadness of “financial circumstances”. Moreover, even just semantically, it is doubtless arguable that “financial information” seems narrower: it likely connotes something like financial facts and figures. In contrast, semantically, “financial circumstances” evokes something much wider: probably a collection of factors and conditions, loosely speaking, is called to mind.²⁶⁴

²⁶⁰ Van der Linde “The solvency and liquidity approach” (2009) 231, footnotes omitted. So a contingent liability does not as yet exist, but it may arise in the future. A provision, on the other hand, is a liability which already exists, but the amount and timing thereof is uncertain. I do not think enough emphasis is placed on the quite important words preceding “contingent”, namely “reasonably foreseeable”. Of course, this markedly narrows the boundaries of contingent assets and liabilities.

²⁶¹ 231.

²⁶² 231.

²⁶³ It should be noted that material contingent liabilities often have to be accommodated in notes to annual financial statements.

²⁶⁴ This by itself cannot be decisive, in my view. But together with the preceding points, I think a convincing case emerges. In an attempt to heed the lessons of chapter 2, this was probably the legislature’s assertion. The semantics (as briefly expounded above) complements the pragmatic elements (here the structure and the use of the word “contingent”, for instance) to supply (what I discern to be) the legal content or assertion of the legislature. Though, as I have been at pains to stress in chapter 2, one should always guard against committing the fallacy of conflating meaning and assertion, perhaps a fair amount of stress or weight can legitimately be placed on the ordinary, semantic meaning of the words, by virtue of the legislature’s championing of the ‘plain language approach’. (Again, however: the semantic meaning of the words *cannot* by itself provide the legal content.)

It can probably not be said that the addition of contingent assets and liabilities in section 4(2)(b)(i) of the 2008 Act, and especially its relationship with the other parts of the section (just discussed), is without problems; but it just about works. A reasonable valuation proffered by a valuator need not necessarily be reflected in accounting records. In that case it will simply not constitute financial information. But, as just illustrated, it need not; ample provision is made for it still to be included in the test as long as it is reasonable.

It can certainly be asked why contingent assets are rendered subject to the condition that they must be considered “whether they arise from a distribution or not”, as it is quite unlikely that a contingent asset would arise from a distribution.²⁶⁵ The insertion of contingent assets and liabilities which will arise from the specific distribution or transaction being proposed stands as a strange requirement. Beside it being unclear as to how contingent assets would be created by a distribution, this requirement ostensibly clashes with the precept that the solvency and liquidity test must be met immediately after completing the distribution or other transaction.²⁶⁶ As soon as a distribution has been made or completed, liability is terminated, meaning the need to include it as a liability vanishes. Van der Linde correctly surmises that the requirement is likely aimed at the situation where the distribution comprises an incurrence of a debt or obligation which is not immediately enforceable.²⁶⁷ In that event, the solvency and liquidity test must be passed when the distribution is authorised.²⁶⁸ All in all, on the issue of contingent assets and liabilities, there is certainly room for improvement in the Act.

It seems that the 2008 Act fails to regulate the position of liabilities under previously authorised but unexecuted distributions. These liabilities – which are existing, not contingent liabilities – have to be included for purposes of the solvency component, according to Van der Linde.²⁶⁹ She suggests that these liabilities cannot be deemed debts due in the ordinary course of business (for purposes of the liquidity element) since they “are enforceable only while the company is solvent and able to pay its debts”.²⁷⁰ The duty to distribute being a rather unique debt, this proposal is sensible. It makes sense for these liabilities to fall below

²⁶⁵ Van der Linde “The solvency and liquidity approach” (2009), 231.

²⁶⁶ 231.

²⁶⁷ 231.

²⁶⁸ Section 46(4)(b). As Van der Linde notes, the requirement cannot operate in the event that the obligation is immediately enforceable, as intended in section 46(4)(a) (231).

²⁶⁹ 231.

²⁷⁰ 231.

the threshold of ‘the ordinary course of business’. The enforceability of these unique duties is no doubt in question should the business no longer constitute a going concern. At least, this theme requires specific regulation; it must be known whether these debts are relevant or not. Van der Linde points to the Model Act as guidance on this score.²⁷¹ Section 6.40(g) explicitly tackles the issue: claims in respect of previously authorised distributions – other than the distribution in respect of which the test is being applied – have to be disregarded if their enforceability is dependent on the corporation’s solvency and liquidity at the time of payment. This approach is laudable. As the issue whether these claims could ever be deemed debts due in the ordinary course of business is undoubtedly an open one, it falls on the legislature to make a decision (to close the issue), and provide clarity.

3.6 Preference Shareholders

According to section 4(2)(c) of the 2008 Act, an application of the solvency and liquidity test in respect of a distribution which takes the form of a transfer of money or property carries a caveat. Unless the memorandum of incorporation states that preferential liquidation rights indeed have to be taken into account as liabilities, the person applying the solvency and liquidity test should *not* include as a liability any amount that would be required to satisfy the preferential rights upon liquidation of classes that have priority over the liquidation rights of those receiving the distribution, if the company were to be liquidated at the time of the distribution. As the Act currently stands, section 4(2)(c) will only be activated if the recipient shareholders also have liquidation rights that are preferential, but rank behind the preferential liquidation rights of another class.²⁷² Because ordinary shareholders do not have preferential liquidation rights, the final mention in section 4(2)(c) of “preferential [liquidation] rights” should have been only ‘liquidation rights’.

This is a strange and regrettable provision. When discussing the emergence of ‘legal capital’, Hanks even states, as a general rule of sorts, that the solvency test “treats liquidation preferences of stock superior to the shares on which the dividend is supposed to be paid as liabilities unless the Charter specifically provides otherwise”.²⁷³ The default rule enshrined in

²⁷¹ 232.

²⁷² This has been paraphrased (the verbatim text quoted above under section 3.3 is slightly different). The crux of the difference is that the paraphrased version drops the third and final mention in the Act of the word ‘preferential’. In my formulation I follow Van der Linde (232, see footnote 64).

²⁷³ Hanks “The new legal capital regime in South Africa” (2010) *AJ* 139.

the 2008 Act asserts exactly the opposite: In the determination of the company's liabilities, any amounts needed if the company were to be liquidated at the time of the distribution to satisfy the preferential rights upon liquidation of preference shareholders are explicitly excluded (unless the memorandum of incorporation provides otherwise). When applying the solvency and liquidity test, therefore, preference shareholders are not sufficiently protected.²⁷⁴

Several additional quandaries and puzzles can be raised here. To begin with, the Act mistakenly speaks of the solvency *and liquidity* test: preferential liquidation rights of preference shareholders are relevant for the solvency, not the liquidity, component, for liquidation rights cannot be deemed debts due in the usual course of business.²⁷⁵ No legal requirement enjoins consideration of fixed preferential dividends with a view to evaluating the corporation's capacity to service its debts in the usual course of business.²⁷⁶

The rationale behind confining the caveat of section 4(2)(c) to distributions by way of transfers – thereby excluding distributions in the form of incurrence or forgiveness of an obligation – is unclear.²⁷⁷ Van der Linde opines that the position regarding parts (b) and (c) of the definition of “distribution” is uncertain.²⁷⁸ Naturally, then, regarding the treatment of parts (b) and (c), there are only two possibilities.²⁷⁹ Van der Linde thinks they are both absurd.²⁸⁰ Either preferential liquidation rights have always to be considered; or they never have to be considered, irrespective of the provisions of the memorandum of incorporation.

This might be too narrow a view. The Act is silent on parts (b) and (c); it is certainly arguable that the provisions of the memorandum of incorporation can play a part. Jooste tentatively embraces the first alternative.²⁸¹ Since nothing is said of distributions by way of debts being incurred, or an obligation or forgiveness of waiver – contained in parts (b) and (c) – the

²⁷⁴ Jooste “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” (2009) 126 *SALJ* 627, 643.

²⁷⁵ Van der Linde “The solvency and liquidity approach” (2009), 232. This is also tacit in the excerpt by Hanks above.

²⁷⁶ 232.

²⁷⁷ 232; Jooste “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” (2009) 126 *SALJ* 627, 643.

²⁷⁸ Van der Linde “The solvency and liquidity approach” (2009), 232.

²⁷⁹ 232.

²⁸⁰ 232.

²⁸¹ Jooste “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” (2009) 126 *SALJ* 627, 644.

preferential rights of preference shareholders have to be included in determining the company's liabilities, says Jooste.²⁸² Van der Linde seems to be non-committal on the best construal of the current wording in the Act. But saying the alternatives are absurd is perhaps overstating it; they will only be unacceptable if they are not subject to the memorandum of incorporation.

Jooste advocates the most lucid stance. The Act only says preferential rights are excluded from the determination of the liabilities for part (a). It might seem a touch fanciful to submit that, owing to the Act's silence in respect of parts (b) and (c), it follows that a positive obligation to the contrary is imposed for these unmentioned parts. But this is in fact the preferable view; and it is not absurd. It must also be remembered that companies can decide the issue for themselves through the memorandum of incorporation. This is expressly stated for the (a) part; and it is implicit for the rest. We are only concerned with an alterable default rule. And if the Act expressly advocates an exclusion exclusively for the (a) part, it seems logical that the default rule should swing the opposite way for the (b) and (c) parts.

Hanks helpfully explains the dynamics underlying the issue, saying that

the balance sheet solvency test [the solvency test] treats liquidation preferences of stock superior to the shares on which the dividend is supposed to be paid as liabilities unless the charter specifically provides otherwise.

Whether to include such an opt-out in the terms of preferred stock is always an important matter for the corporation, the prospective preferred stock investors and their counsel to consider. On the one hand, the investors and their counsel may not be inclined to agree to an opt-out, and insist on having their senior liquidation preference treated as a liability, which will result in a dollar-for-dollar additional block on the corporation's power to make distributions to junior stockholders, thus increasing the cushion of assets available for payment to creditors and to the preferred stockholders. However, the preferred share investors also have an interest in the corporation's being able to raise additional common and other junior equity, which will serve as further support for the corporation's ability to pay the preferred equity dividends and, if necessary, its liquidation preference. Thus, the potential preferred investor will often agree to the opt-out.²⁸³

²⁸² 644.

²⁸³ Hanks "The new legal capital regime in South Africa" (2010) *AJ* 139.

Clearly, it is best to have an alterable – not a compulsory – rule on this issue. But the legislature unfortunately starts from the wrong premise. It seems an amendment is definitely required.

Notably the 2008 Act only addresses preferential rights on liquidation. There is not any mention of fixed preferential returns on shares ranking ahead of those in respect of which a distribution is made.²⁸⁴ It is not really known whether such returns must be considered. It is perhaps curious that the provision does not deal with all the rights that are subordinated (or treated equally) to those of the shareholders who receive the benefit, for the purpose of which solvency and liquidity must be determined.

All in all, the South African position in this regard is unequivocally out of step with international standards. The position in the Model Act,²⁸⁵ California, and New Zealand specifically accommodates preferences to shareholders in these circumstances: the interests of preference shareholders are safeguarded through qualifications or adjustments to the solvency component.²⁸⁶ California also supplies a precedent for the provision of arrear cumulative dividends.²⁸⁷

Van der Linde sums up the situation and the reason for a proposed amendment by saying that

[i]t is difficult to justify why a company that has chosen to provide preferential rights to the return of capital should be allowed to make distributions to ordinary shareholders that will endanger those rights. At least, if the memorandum [of incorporation] is required to provide expressly that liquidation preferences will not be taken into account when distributions are made, potential investors in preference shares will be alerted to this fact and can make an informed decision.²⁸⁸

²⁸⁴ Jooste “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” (2009) 126 *SALJ* 627, 643.

²⁸⁵ Section 6.40(c)(2).

²⁸⁶ Van der Linde “The solvency and liquidity approach” (2009), 232. She also notes that preference shareholders are also afforded protection under capital maintenance systems like the United Kingdom and Delaware. As regards dividends, the entrenchment of the right to receive dividends follows from the terms of issue of the preference shares. As regards liquidation preferences, protection accrues, quite naturally, by way of the rule that contributed capital – including the capital in respect of which the preference is enjoyed – has to be maintained (233).

²⁸⁷ 233.

²⁸⁸ 233.

It is interesting to note that the provision under discussion was the subject of an amendment under the Companies Amendment Act 3 of 2011. Regrettably, none of the issues tackled here were addressed and the provision remains a disappointment.

3.7 When should the solvency and liquidity test be applied?

The timing for the application of the solvency and liquidity requirement is another important and difficult consideration. In this regard it is vital to separate two aspects: the moment the test should be considered, and the moment with reference to which the requirements must be met.²⁸⁹ As to the former, the test must be considered at the time the company intends to make a proposed distribution.²⁹⁰ Van der Linde concludes this is a reference, not to the time of the initial authorisation (of the distribution), but to the time of an intended transfer of money or property.²⁹¹ Regarding the latter – the time at which the test must be satisfied – the 2008 Act designates different timing rules correlating with different types of transactions. The general rule is evidently that the test must be satisfied after the completion of a distribution or transaction.²⁹² The effect of financial assistance must be gauged “immediately after providing the financial assistance”,²⁹³ and “upon implementation” when it comes to mergers or amalgamations.²⁹⁴ The details are spelled out below.

A special timing rule, moreover, applies to a distribution in the form of an incurrence of an obligation or debt.²⁹⁵ Section 46(4)(a) stipulates that the effect of this kind of distribution must be determined by reference to the time it is authorised (and not when the obligation or debt is satisfied). The test must be met, that is, “at the time that the board resolves that the company may incur that debt or obligation; and...[does] not apply to any subsequent action of the company in satisfaction of that debt or obligation, except to the extent that the resolution, or the terms and conditions of the debt or obligation, provide otherwise”.²⁹⁶ Van der Linde speculates that this holds even where the company “will only incur the obligation at a future

²⁸⁹ 233.

²⁹⁰ Sections 46(1)(b) and 46(4) of the 2008 Act.

²⁹¹ 233. Paragraph (a) of the definition of a distribution as a transfer by a company of money or property is said to confirm this; each payment would hence constitute a distribution (233).

²⁹² Section 46(1)(b) – the test must be satisfied “immediately after completing the proposed distribution”.

²⁹³ Section 44(3)(b)(i) and section 45(3)(b).

²⁹⁴ Section 113(1).

²⁹⁵ Paragraph (b) of the definition of distribution.

²⁹⁶ Section 46(4).

date or subject to fulfilment of a condition”.²⁹⁷ A sound interpretation of this provision is tricky since, not only the financial limitations, but also all the requirements of the provision (including the board resolution), must be applied at the time of the resolution.²⁹⁸

Jooste is critical of the exception created by section 46(4)(a). He is of the view that the test should be satisfied after the debt has been incurred, not at the time of authorisation.²⁹⁹ He is sceptical of the exception because no reason exists for a departure from the general rule. The critical time is only after the (proposed) distribution has been made; likewise the test must be satisfied after the debt has been incurred. In addition, nothing is said of the forgiveness or waiver of a debt.³⁰⁰ Conceptually, this kind of distribution is similar; it is merely the converse of an incurrence of debt. The general rule arguably applies to this type of distribution, since no exception was created specifically for it. Jooste’s argument is in effect, because the incurrence of the debt amounts to the actual distribution, the general rule should apply, just as it does for forgiveness and waiver.

The purported justification for the exception introduced in section 46(4)(a) ostensibly would run along the following lines. One should take proper account of the fact that the shareholders’ rights to company property or money is always subservient to that of the corporate creditors. Property or money can only be distributed if, at the time of the transfer, the financial requirements will be satisfied. Specifically: once the transfer has been completed, the company must still be financially viable. In contrast, when distributing a duty, a shareholder acquires a right – for this purpose the shareholder becomes a creditor – which is enforceable regardless of whether the company is solvent and liquid at the time of enforcement.

Though the intention of the legislature is fairly clear, its assertion is in the final analysis not well supported. The moment of authorisation should not be the relevant time for determining solvency and liquidity where obligations are distributed. Solvency and liquidity is only determined once: since it is the duty that is distributed, the distribution for all intents and purposes occurs when the duty originates. This should be the relevant time. The moment of authorisation will probably approximate more closely to this time, as compared with the

²⁹⁷ Van der Linde “The solvency and liquidity approach” (2009), 234.

²⁹⁸ 234.

²⁹⁹ Jooste “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” (2009) 126 *SALJ* 644.

³⁰⁰ Paragraph (c) of the definition of “distribution”.

moment of actual payment (performance of the obligation). Nevertheless, the pertinent date or time should be the date or time of the genesis of the duty. A creative interpretation, in view of the interpretation theory espoused in chapter 2, cannot remedy this defect. A substantive amendment will be necessary.

The further problem with the current wording is that distinguishing the various types of distribution is no easy task. Usually, in the payment of dividends, upon the approval by the company, the shareholders will acquire the right to a dividend, whilst the company will be under a duty to pay on the date stipulated in the approval. Hence, even in the case of dividends, a duty exists before the distribution is made. It seems that the ultimate determinant of which timing requirement applies in a particular case is the actual formulation employed by the company when determining that a distribution will be made. The question will be whether the specific formulation most closely aligns with the essence of a paragraph (a) distribution, or with a paragraph (b) distribution.

A useful comparison can in this context be made to the Model Act. As with most systems the financial limitations have to be satisfied at the moment of giving effect to a distribution, while the Model Act accepts that this can occur at different points in time for different distributions.³⁰¹ The general timing principle is that distributions take effect on the date of authorisation (if, and only if, payment is made within 120 days of the authorisation).³⁰² In the event that payment occurs in excess of 120 days after the authorisation, the financial limitations must be satisfied at the time of actual payment.³⁰³ Where a duty or debt is distributed, the test must be passed on the date the duty or debt is distributed. This is so unless each payment is made subject to the company's solvency, and the debt is subordinated to the debts of ordinary trade creditors.³⁰⁴ Like the 2008 Act, special timing rules operate in the case of the distribution of indebtedness. The Model Act, however, uses the date on which the debt is incurred as the central point of reference.

The Model Act further adds the useful qualification that this rule will apply only where the shareholder will become an ordinary creditor after distribution. The provision accordingly is

³⁰¹ Section 6.40(e) read with (g) of the Model Act.

³⁰² Section 6.40(e)(3) of the Model Act.

³⁰³ Section 6.40(e)(3) of the Model Act.

³⁰⁴ Section 6.40(e)(2)(g) of the Model Act.

more carefully formulated than its South African equivalent. The difference in timing rules can be explained by the status of a shareholder's claim regarding a previously authorised distribution: where a shareholder gets an unconditional and unsubordinated claim which is immediately enforceable, the test must be met when the claim originates.³⁰⁵ Where the claim is subordinated, the requirements must be satisfied at the time of actual payment.³⁰⁶

The distinction drawn at the beginning of this section, between the moment the test should be considered, and the moment with reference to which the requirements must be met, has not been cleanly enacted in South Africa. Section 4(1) speaks of "at a particular time" and "at that time". It seems that these phrases refer to the time at which the test must be met. But the provision says that "reasonably foreseeable financial circumstances...at that time" must be considered. This might cause confusion because the assessment of solvency and liquidity must obviously be carried out in respect of reasonably foreseeable facts *at the time the test is considered*. It could thus be said that the future date is invoked in respect of the first quoted phrase, whereas the time the test is considered seems to be suggested by the second phrase. Reasonably foreseeable financial circumstances would only be relevant to solvency if solvency had to be measured in respect of a future date.

What is more, section 4(1)(b) gives rise to a similar problem: the period over which liquidity must be determined is said to start when the test is considered. It would seem that the legislator here wanted the starting point for the liquidity period to commence at the same time as the point from which liquidity has to be determined. The introductory portion of section of 4(1) covers the liquidity part too: "all reasonably foreseeable financial circumstances...at that time", which again makes sense only if it refers to the moment that liquidity is considered (not the moment with reference to which the test must be passed). An amendment unbundling the two parts in the introduction to section 4(1) is needed to solve these problems. That said, it is difficult, notwithstanding the careless drafting, to interpret these provisions incorrectly. A sensible interpreter should be able to make sense of these provisions. But, at the same time, it certainly should not be so difficult to gauge the content here and it is submitted that an amendment clarifying the timing elements is necessary. The timing dilemmas under this section will be analyzed below particularly with distributions in mind.³⁰⁷

³⁰⁵ Van der Linde "The solvency and liquidity approach" (2009), 235.

³⁰⁶ 235.

³⁰⁷ See 4.2 below.

Furthermore, these provisions become problematic when they are applied in conjunction with s 46. Section 46(1)(c) read with section 46(4) is consistent with section 4 as regards part (a) and (b) distributions. But, according to section 4, the liquidity period for a part (c) distribution must be determined from the time when the resolution is made while section 46(4) does not expressly require that liquidity and solvency for part (c) distributions must be determined at the time when it is resolved to make a distribution. As I have argued, previously part (b) and (c) distributions should be considered on the same footing.³⁰⁸ Amendments are needed to this effect. In such an amendment, exceptions to the section 46(1)(c) rule should be clear; and the relationship between this section, section 46(4) and section 4 should be coherent.

Finally, in terms of section 46(1)(b), solvency and liquidity must be considered from the time of the distribution in the case of part (b) distributions. However, section 46(4) takes the board resolution as its point of reference. It could perhaps be argued that section 46(4) does not override section 46(1)(b) which is not formulated with reference to resolutions of the board. Though hardly a model of clarity, upon reading the provisions, the relationship between these sections still can be read to make sense. A particular kind of distribution – part (b) distributions – is treated separately: it is stated that the general requirements for distributions are modified with respect to this particular type of distribution. Liquidity and solvency in terms of s 46(1)(b) must also be determined with reference to the time of the resolution rather than the time of completing the distribution. That is to say, the legislature's assertion here is probably just about coherent, as section 46(4) is meant to prevail over section 46(1).

3.8 How should the test be applied?

Several options emerge here. It remains to analyse the legislature's choices regarding the manner of application of the solvency and liquidity test.

³⁰⁸ See page 84 above.

Crucially, it should be settled whether an objective or subjective enquiry is called for. Section 46(1)(b) is the decisive provision for purposes of answering this question.³⁰⁹ A company is prohibited from making a distribution “unless it reasonably appears” that the company will satisfy the test after completing the proposed distribution. There is no mention of the (subjective) belief or the perspective of the board. We are not told to whom it should so “reasonably appear...”. It seems appropriate to assume that the test must therefore be applied from the perspective of an objective bystander.

Objective standards often apply by virtue of the qualifier ‘reasonably’. It is submitted that an objective, rather than a subjective, test has been adopted. Van der Linde maintains that the existence of a reason or ground upon which a conclusion could reasonably be reached is the “determining factor”.³¹⁰ The facts constituting these grounds do not have to be assessed from the perspective of the board. But, in evaluating compliance, only the facts that were reasonably available at the time of the distribution can be considered in ascertaining whether the test is satisfied. A court may hence consider all the relevant facts but it is confined to the facts available at the time of the distribution, as opposed to facts available when the decision was made.

The next important issue is the choice in section 4 of working with a *prediction* of solvency and liquidity as compared with *actual* solvency and liquidity, in determining whether the board has properly authorized a distribution. As for solvency, it is clear that this component hinges on a prediction of the position immediately after completion of the distribution (or transaction), and not the actual financial position of the corporation. In a similar vein, the liquidity test is also based on a prediction. As the predictive element of the solvency and liquidity test is built in, the test will be satisfied even in case the prediction later turns out to be inaccurate (if the prediction was at least reasonable).

Equally, if the prediction was unreasonable at the time, but subsequently turns out to be accurate, the distribution is nevertheless unlawful.³¹¹ Van der Linde points out that a potential conflict with insolvency law looms here as a distribution which is legitimate in terms of the

³⁰⁹ All the distribution provisions, including this one, receive detailed attention again, in the following chapter. The considerations highlighted under this section – as with the previous sections – do not amount to the final word on the issues raised.

³¹⁰ Van der Linde “The solvency and liquidity approach” (2009), 235.

³¹¹ But naturally, it is improbable that proceedings will be commenced to recover the illegal distribution.

Act because insolvency could not be predicted could still be a disposition without value in insolvency law, because of actual insolvency.³¹² However, she probably overstates the point. Insolvency and company law in these situations supplement one another. This is also the case with many other transactions.

The broad equivalent of the solvency component in California is based on a prediction (made immediately before the distribution).³¹³ Under the Model Act the *lawfulness* of a distribution is dependent on the company's *actual* (not predicted) compliance with the test when the distribution is made. But the Model Act provides that a distribution can only be made if the company will be solvent and liquid after making it (which is measured from the authorisation if payment occurs within 120 days).³¹⁴ Hence, while lawfulness is indeed contingent on actual compliance, a prediction of the company's future financial position is still required.

But, the precise extent to which the determination of liquidity and solvency will be predictive will depend on the reason for which it is analysed. It will therefore be difficult to harmonize the predictive elements of the definition of solvency and liquidity with the more specific provisions where solvency and liquidity requirements are applied. For our purposes it is particularly relevant to determine how the solvency and liquidity requirement will be applied in the context of distributions. Several provisions impact on this topic. Section 46(1)(b) determines that a distribution *inter alia* only be made if it "reasonably appears" that these requirements will be met. Section 46(1)(c) similarly requires that the directors must acknowledge that they have reasonably concluded that the solvency and liquidity test has been met. Section 46(6) imposes liability on a director who did not vote against a distribution although he knew or reasonably should have known that any of the requirements in s 46(1) were not met.³¹⁵ Section 77(4)(a)(i) excludes liability where the solvency and liquidity test is actually not met after a distribution has been made. Section 77(4)(a)(ii) excludes liability where it was reasonable at the time of the decision to distribute, to think that the solvency and liquidity requirement would be met after the distribution had been made. Apparently section 46(1)(b) (although the Act is also open to a different interpretation here) and 77(4)(a)(i) work with actual solvency and liquidity. They are prospective only in that liquidity will still

³¹² 236. In an insolvent winding-up, in order to evaluate whether the payment will be voidable or not, the actual solvency of the corporation at the time of payment or disposal is assessed (section 26 of the Insolvency Act 24 of 1936).

³¹³ Van der Linde "The solvency and liquidity approach" (2009) 236.

³¹⁴ Section 6.40(e)(3) of the Model Act.

³¹⁵ This section must be read with the definition of knowing, knowingly and knows in section 1.

have to be determined with reference to a future period. The other provisions require that decisionmakers make a reasonable assessment of liquidity and solvency at the time of decisionmaking. They accordingly are predictive in the strict sense.

However, van der Linde contends that the rationale for the above distinction disappears because of the way in which the distinction is worded in the 2008 Act. That is, the predictive element has been built into the solvency and liquidity test itself, meaning “there is no basis for working with *actual* solvency and liquidity”.³¹⁶ For this argument she relies on the introductory, all encompassing part of section 4(1), which covers both the solvency and liquidity elements. She proposes the following solution: that the phrase “considering all reasonably foreseeable [financial] circumstances at the time” be deleted from the introductory sentence of the solvency component and inserted at the start of the liquidity component.³¹⁷

This appears to be a relatively tidy solution and her suggestion may be a laudable improvement overall. However, it is doubtful whether Van der Linde is right in her initial observation. Though the predictive element is indeed built into the solvency and liquidity test, I do not see why actual solvency and liquidity cannot be gauged after the fact, which means that liability could be ascertained in terms thereof. Section 4 is predictive, whereas section 46(1)(b) and 77(4)(a)(i) invoke the actual financial position of the company. Sections 46(1)(c), 46(6)(b) and 77(4)(a)(ii) introduce an *objective* (or factual) but predictive yardstick, serving as the limits of directorial liability, which exist independent of the predictive functioning of the solvency and liquidity test in section 4.

A rigorous scheme emerges in terms whereof a distinction is made between applying the test for the purpose of determining the lawfulness of distributions on the one hand and the liability of directors for unlawful distributions on the other.³¹⁸ Authorization by directors and their ensuing liability if this not properly done, must be premised on a prediction about the corporation’s solvency and liquidity. For this reason sections 46(1)(c), 46(6)(b) and 77(4)(a)(ii) which concern liability and actions of directors are predictive. Section 77(4)(a)(i) is not predictive but is necessary to limit liability with reference to actual solvency and

³¹⁶ Van der Linde “The solvency and liquidity approach” (2009) 236 (my emphasis).

³¹⁷ Van der Linde “The solvency and liquidity approach” (2009) 237.

³¹⁸ Van der Linde “The solvency and liquidity approach” (2009) 236.

liquidity. Rather than being concerned about the accuracy of predictions, however, creditors' interests are impacted by actual solvency and liquidity.³¹⁹ Mere non compliance with the non-predictive section 46(1)(b) will mean that a distributions will be unlawful and this will be in the interest of creditors because distributions will be recoverable from shareholders, but it will not by itself lead to liability for directors. The scheme certainly can be clarified and simplified. The role which section 46 plays in determining the lawfulness of a distribution irrespective of liability can be expressed more clearly. The relationship between the liability provisions in section 46 and the limitation provisions are not unproblematic.³²⁰ Nevertheless the basic tenor of these provisions is clear.

The next issue to be considered is the nature of the duty to apply the solvency and liquidity test – in this sense one can speak of a positive or a negative duty.³²¹ Is a passive or an active approach to solvency and liquidity followed; does the company (and its board) bear a positive or a negative duty? Under sections 85(4) and 90(2) of the 1973 Act, payment was allowed as a general rule, unless there were reasonable grounds to believe the company was insolvent or was incapable of paying its debts. This was, in other words, a passive approach.

Under the 2008 Act, however, positive steps are required from the board to establish solvency and liquidity. But this is expressed in a rather curious manner, as the language adopted is far from unified. The particular action which the board is required to take with respect to solvency and liquidity is variously described. Looking at sections 44 and 45 – concerning the financial assistance transactions – the board has to be “satisfied” that the company will meet the test. Regarding section 46 – distributions – the board must adopt a resolution acknowledging it has “applied” the test and “concluded” that the company will satisfy it. As to section 47 – when cash is distributed in lieu of capitalisation shares – the board has to “consider” the test, as well as be “satisfied” that the company will satisfy the test. Regarding mergers and amalgamations the board must “consider”³²² the test and “reasonably believe”³²³ it will be satisfied. In all of these situations, therefore, the required manner of application of the solvency and liquidity test is differently described. Van der Linde believes that these

³¹⁹ Van der Linde “The solvency and liquidity approach” (2009) 236.

³²⁰ It may be difficult to distinguish the roles of the liability provisions in section 46 and the exclusion provisions in section 77(4), see further 5.4. Van der Linde “The solvency and liquidity approach” (2009) 236 the last paragraph, which distinguishes authorization and liability, seems to add to this confusion.

³²¹ Van der Linde “The solvency and liquidity approach” (2009) 237.

³²² Section 113(4)(a).

³²³ Section 113(4)(b).

subtle differences will cause unnecessary complexity.³²⁴ The acknowledgement in the case of distributions is a unique case (I will focus more closely on this in subsequent chapters).

Apart from that, can one reasonably speak of a meaningful or practical difference between concluding, being satisfied, and reasonably believing? Certainly an argument can be made that the variation in expression is deliberate; that the legislature had something particular in mind when using each of these terms; a different legal assertion may technically have been enacted. But, supposing no amendments are in the offing and these terms will remain, it is probably of no consequence. For practical purposes, there is no difference between concluding and being satisfied the test will be met. Nevertheless, this is not true of the phrase “reasonably believe”. This formulation is ubiquitous in legal materials and it may come with a fair amount of baggage.

Likewise: does considering and applying the test amount to the same thing? For all intents and purposes, it appears so. Where a board of directors concretely is obliged to realize one of the mentioned provisions, and is enjoined, say, to “consider” the test, from the point of view of the board members, the board may just as well have been enjoined to “apply” the test. Nevertheless, in order to avoid any confusion, an amendment integrating these terms is desirable, so that one term is consistently and uniformly used. Notwithstanding the differential formulation, it is certain the board bears a positive duty to consider or apply the test.³²⁵

3.9 Conclusions

It is now clear that a solvency and liquidity test is the chosen method for protecting creditors in the case of distributions to shareholders (and other transactions potentially influencing creditor interests). On the basis of the arguments above, it appears this test is a suitable limitation on distributions to shareholders. The pervasive function of the test in terms of the 2008 Act seems to be a generally positive move. It has, however, been shown that the introduction of a solvency and liquidity philosophy in the 2008 Act is beset with demonstrable problems. These mainly go to the mechanics of its implementation; in this

³²⁴ Van der Linde “The solvency and liquidity approach” (2009) 237.

³²⁵ Van der Linde “The solvency and liquidity approach” (2009) 237.

regard the Act has not been carefully and thoughtfully worded. The rectification of some of these problems is possible through shrewder formulation and meticulous cross-referencing.

Van der Linde maintains that “the lack of nuanced application of the test in the different contexts of authorisation, validity and liability can only be corrected by substantive revision”.³²⁶ It has been briefly suggested where and to what extent this will be necessary. Later in the study positive proposals (with accompanying commentary) are advanced.³²⁷ It is probably already fair to conclude that the purposes of section 7 play no role in the interpretation of solvency and liquidity. This conclusion will possibly hold for the distribution provisions, and most likely corporate finance as a whole. As a pragmatic tool, it may prove more beneficial to view the distribution provisions through the prism of the dynamics of solvency and liquidity.

³²⁶ 240.

³²⁷ See chapter 6 below.

Chapter 4

Authorisation of a Distribution, Acknowledgement of Solvency and Liquidity, and Related Requirements

4.1 Introductory

The 2008 Act does not regulate different kinds of distributions separately. Instead the aim is to deal with distributions to shareholders in a unified way by defining the term “distribution” and subjecting instances complying with this definition to the same requirements. This strategy does not really work because of the flawed drafting of the relevant provisions. It often appears as though the legislature did not intend to bring about certain effects which would seem to follow from the language employed. Especially in these cases a nuanced understanding of legal interpretation and the limits of authoritative law-making is required.

But some parts of these provisions are simply mistakes and need to be corrected as soon as possible. The obvious example is the arbitrary extension of the regulation of distributions to apply within the group context. It is only the acquisition of shares by a subsidiary in its holding company which needs to be regulated. The inclusion of the qualifier “indirect” in the definition of “distribution” is arguably sufficient to counteract possible circumvention of the Act by groups of companies. Moreover, when compared to payments for shares under a court order, the exclusion of payments under the appraisal remedy from the definition of “distribution” is questionable.³²⁸

Barring those made in compliance with a court order or pursuant to an existing obligation, distributions must be authorised by the board of directors.³²⁹ This must be distinguished from an acknowledgement of solvency and liquidity: before making a distribution, the board of directors must acknowledge that it has applied the solvency and liquidity test and has reasonably concluded that the company will satisfy the test immediately after completion of the proposed distribution.³³⁰ As will be explained, the 2008 Act does not consistently and rigorously distinguish these two elements. These requirements will probably cultivate responsible directorial behaviour in connection with distributions, but numerous problems

³²⁸ Van der Linde “The regulation of distributions” (2009) *TSAR* 500.

³²⁹ See sections 46(1)(a)(i) and (ii) of the 2008 Act.

³³⁰ Section 46(1)(c).

emerge in this context and it is the object of this chapter to flesh these out and to hint at the ultimate form of workable solutions. This will prove a complex task.

It will be seen that the considerations which crop up under this heading are coloured by the dynamics of the financial restrictions spelled out in the previous chapter; and both these collective themes are in turn inextricably tied to the issues which crop up under directorial liability. Examples are easy to come by. The myriad difficulties surrounding solvency and liquidity (spelled out in the previous chapter) obviously come up in the requirement of the acknowledgment.³³¹ Also, the fact that the distinction between the authorisation and the acknowledgment is not soundly devised can be gauged from the fact that liability is imposed on directors on grounds of their participation in the authorisation and not the acknowledgment. Arguably, because directors are liable solely in connection with their failure to comply with the financial limitations, their liability should be contingent on participation in the acknowledgment.³³² These are the types of problems that will be considered below. But final conclusions will only be drawn by the end of the next chapter, as the full picture will then be discernible, with directorial liability completing the picture. Precisely because of their interdependence, logically schematising the various issues is difficult. The best approach may simply be to go through the provisions in the order in which they appear in the Act.

4.2 Section 46 of the 2008 Act

It is extremely difficult to make sense of all the provisions of section 46; and its relationship with solvency and liquidity on the one hand, and directorial liability on the other is sometimes cumbersome and often intractable. It is therefore essential to reproduce the actual wording of the section below. This will also be useful for the analysis in subsequent chapters.

46. Distributions must be authorised by board.—(1) A company must not make any proposed distribution unless—

(a) the distribution—

(i) is pursuant to an existing legal obligation of the company, or a court order; or

(ii) the board of the company, by resolution, has authorised the distribution;

(b) it reasonably appears that the company will satisfy the solvency and liquidity test

³³¹ Also see section 46(1)(b) which invokes the solvency and liquidity test.

³³² This is the view of Van der Linde, see 496.

immediately after completing the proposed distribution; and

(c) the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test, as set out in section 4, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.

(2) When the board of a company has adopted a resolution contemplated in subsection (1) (c), the relevant distribution must be fully carried out, subject only to subsection (3).

(3) If the distribution contemplated in a particular board resolution, court order or existing legal obligation has not been completed within 120 business days after the board made the acknowledgement required by subsection (1) (c), or after a fresh acknowledgement being made in terms of this subsection, as the case may be—

(a) the board must reconsider the solvency and liquidity test with respect to the remaining distribution to be made pursuant to the original resolution, order or obligation; and

(b) despite any law, order or agreement to the contrary, the company must not proceed with or continue with any such distribution unless the board adopts a further resolution as contemplated in subsection (1) (c).

(4) If a distribution takes the form of the incurrence of a debt or other obligation by the company, as contemplated in paragraph (b) of the definition of “distribution” set out in section 1, the requirements of this section—

(a) apply at the time that the board resolves that the company may incur that debt or obligation; and

(b) do not apply to any subsequent action of the company in satisfaction of that debt or obligation, except to the extent that the resolution, or the terms and conditions of the debtor obligation, provide otherwise.

(5) If, after considering the solvency and liquidity test as required by this section, it appears to the company that the section prohibits its immediate compliance with a court order contemplated in subsection (1) (a) (i)—

(a) the company may apply to a court for an order varying the original order; and

(b) the court may make an order that—

(i) is just and equitable, having regard to the financial circumstances of the company; and

(ii) ensures that the person to whom the company is required to make a payment in terms of the original order is paid at the earliest possible date compatible with the company satisfying its other financial obligations as they fall due and payable.

(6) A director of a company is liable to the extent set out in section 77 (3) (e) (vi) if the director—

(a) was present at the meeting when the board approved a distribution as contemplated in this section, or participated in the making of such a decision in terms of section 74; and

(b) failed to vote against the distribution, despite knowing that the distribution was contrary to this section.

Broadly, three requirements emerge for the making of a distribution. First, distributions have to be authorised by the board of directors (except those made in compliance with a court order or pursuant to an existing legal obligation).³³³ Second, it must reasonably appear that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.³³⁴ Lastly, the board of the company must acknowledge that it has applied the solvency and liquidity test and has reasonably concluded that the company will satisfy the test immediately after completing the proposed distribution.³³⁵

As to the first requirement, one could question what is meant by “existing legal obligation”. As a general rule distributions are made in terms of existing legal obligations at any rate. On the face of it the intention seems clear enough, as it is paired with “court order”: an authorisation will be required in cases where the board is afforded a measure of discretion in respect of a distribution – i.e. cases where the distribution is not dictated by an external fact.³³⁶ The striking thing about the authorisation requirement is that the board now has all the power. Under the 1973 Act shareholder approval was required. This is no longer the case. The 1973 Act did not impose directorial liability for unlawful distributions. The 2008 Act does. Hence, it arguably makes sense to afford this expansive power to the board. As to timing: it seems the authorisation by the board can be given at any time before the distribution is made.

The question is prompted whether the memorandum of incorporation can still validly provide that shareholder approval is a requirement for a distribution. Section 46 is clearly not an alterable provision.³³⁷ Thus section 15(2)(a)(iii) must be complied with. This provision stipulates that the memorandum of incorporation may include any provision which imposes a higher standard, greater restriction or more onerous requirement on the company than would otherwise apply under an unalterable provision (i.e. section 46) of the Act. So the question becomes: would adding such a requirement to the memorandum of incorporation impose a more onerous requirement than would apply if mere board authorisation was required? It is not clear from whose perspective exactly the requirement should be stricter or more onerous.

³³³ Section 46(1)(a)(i) and (ii).

³³⁴ Section 46(1)(b).

³³⁵ Section 46(1)(c).

³³⁶ I do not mean ‘agency’ in a legal sense.

³³⁷ Section 1 “unalterable provision”.

This might depend on the specific stakeholder under consideration. It accordingly is impossible to provide an absolute answer to this question.

Van der Linde takes the view that a company's memorandum of incorporation *can* impose the requirement of shareholder approval (in addition to the statutorily required board authorisation).³³⁸ But this view is not substantiated. Presumably she takes it for granted that adding the shareholder approval requirement renders the (overall) requirement(s) more onerous. Intuitively, this seems to be the better view. I think the Act indeed allows such a requirement to be imposed in the memorandum of incorporation. Plainly, if the memorandum of incorporation so provides, there is an additional obstacle before the distribution will be allowed. Board and shareholder approval is then necessary and this surely constitutes "a higher standard", "a greater restriction" or a "more onerous requirement".³³⁹ If merely board approval was required, intuitively, a less onerous requirement for a distribution would apply.³⁴⁰

I turn now to the second requirement: that it must reasonably appear that the company will satisfy the test immediately after completing the distribution. This is clearly an objective test.³⁴¹ At first blush, this provision seems self-evident (the ensuing analysis will later suggest why this may not be the case). This provision ostensibly makes clear that compliance with the solvency and liquidity test, as encompassed in section 4, is mandatory for all distributions. The phrase "it reasonably appears" enjoins the company to consider objectively determinable facts.³⁴² It is not enough to assert that the time at which solvency and liquidity must be determined for the purpose of section 46(1)(b) is the time at which the distribution is completed. The question is from which point must it be considered. It may be cogently argued either that this provision uses the time when the company decides to make a distribution or the time at which the distribution has been made. However, it is suggested that the latter view is preferable. So far, the purpose of the three parts under section 46(1) seems obvious: the first part refers to the authorisation, the second the solvency and liquidity test, and the last part the acknowledgment.

³³⁸ 492.

³³⁹ Section 15(2)(a)(iii).

³⁴⁰ The Act says the memorandum of incorporation may include any provision "imposing on the company" a more onerous requirement than would otherwise apply. I believe my analysis is consistent with the perspective invoked – i.e. that of the company.

³⁴¹ See 3.8 above.

³⁴² See 3.7 above: the issue of timing here is mirrored in my discussion of section 4 of the 2008 Act.

The third requirement pertains to the acknowledgment. This requirement is rather sloppily worded. It can easily be divided into two parts. The first part says that the board must acknowledge that it has applied the solvency and liquidity test (as contained in section 4); the second part continues “and reasonably concluded that the company will satisfy” the test “immediately after completing the proposed distribution”. The following interpretation thus seems possible: the Act merely requires that the directors have to *declare* that their conclusion is reasonable, not that their conclusion actually has to be reasonable.³⁴³ But this does not seem very plausible; all things considered, this does not seem to me to be the legislature’s assertion.

It would be excessively fanciful or pedantic to read the Act in such a formalistic way. It seems obvious that the legislature intended to convey that the board has to acknowledge it has applied the test *wherein* it in fact reasonably concluded the company will meet the test after completing the distribution. Either the actual “reasonable conclusion” is implicit in the acknowledgment mentioned in the first part; or the second part explicitly ensures there will be a reasonable conclusion. Otherwise the acknowledgement’s function would be in question. The context of the provision appears to confirm this. The provision does not say: the board must acknowledge *that* it reasonably concluded the test will be passed. The “reasonably concluded” part is separate; it seems to be emphasised. The perlocutionary intent – or larger reason – behind this provision is to guarantee the making of a proper acknowledgement of solvency and liquidity in the case of all distributions, ensuring responsible distributions not compromising the position of creditors (and shareholders). The illocutionary intent – which provides the law’s ultimate content – here seems to compel a recognition on the part of the interpreter that an acknowledgment has to be made and that it has in fact to be based on a reasonable conclusion of solvency and liquidity.³⁴⁴ Nevertheless the careless drafting would ideally need reformulation to avoid any confusion.

It appears that section 46(1)(a) operates independently of section 46(1)(c): the resolution acknowledging the application of the solvency and liquidity test is required even if the

³⁴³ Directors could perhaps be liable if the statement is false but, on this reading, not under this provision; a reasonable conclusion in fact is not required but only an *acknowledgement* that there was a reasonable conclusion. (On this reading, it is possible that liability can be imposed on directors if it becomes apparent that the acknowledgement was intentionally incorrect or fraudulent.)

³⁴⁴ See especially pages 41 to 42 for an explanation of the distinction between illocutionary and perlocutionary intentions.

distribution itself was not authorised by the board of directors but is pursuant to a court order or existing legal obligation. Some cases, thus, require board authorisation; all cases require an acknowledgement of solvency and liquidity. The resolution authorising a distribution must be kept apart from this acknowledgement. It is questionable, however, whether the legislature has consistently done so. It seems the board can make the acknowledgement at any time before the distribution. But does the acknowledgement have to be made before the authorisation? The Act does not prescribe a particular sequence as regards the authorisation and the acknowledgement. It is doubtful whether much can be inferred from the order in which the requirements are laid out – i.e. the authorisation is mentioned first. This issue is especially crucial because it influences directorial liability for unlawful distributions. It could well be that, in all cases where an authorisation is required, it should occur after the acknowledgement has been made. If this were not so, liability could follow if a director authorises a distribution knowing that an acknowledgement is yet to be made (i.e. knowing that all the requirements of section 46 are not satisfied).

The introduction of a declaration or formal acknowledgement resolution of solvency and liquidity, in principle, seems laudable. Along with auditor confirmation, this is also mandatory in England; and a solvency certificate has to be signed in New Zealand; something similar can also be seen in the Model Act.³⁴⁵ A positive duty is imposed on directors, meaning the likelihood of unlawful distributions prejudicing the interests of creditors (and shareholders) is diminished. On the other hand, it is also true that the requirement reduces flexibility, as a particular date emerges for the application of the financial restrictions.³⁴⁶ To address this, the possibility of a reconsideration is also provided for: section 46(3) caters for this in terms of a 120 day rule. Section 46(3) has to be read with 46(2). These two provisions together cause quite a bit of trouble.

Section 46(2) states that when the board has made an acknowledgment, the relevant distribution must be fully carried out, “subject only to subsection (3)”. The board thus has a duty to distribute after it made the acknowledgement, subject to section 46(3). Essentially, what section 46(3) requires is that, if the distribution has not been completed within 120

³⁴⁵ See section 173(3)(5) of the British Companies Act 1985, section 714(3) and (5) of the UK Companies Act 2006 where it is referred to as directors’ ‘statement’; section 52(2) of the New Zealand Companies Act 1993; section 6.40(g) of the Model Act. See also Van der Linde “The solvency and liquidity approach in the Companies Act 2008” (2009) 2 *TSAR* 224, 238.

³⁴⁶ 238.

business days after the board made the acknowledgement, the board is under a duty, one, to reconsider the solvency and liquidity test, and, two, not to distribute unless a new acknowledgement has been made.³⁴⁷ Literally read, the board will be under a duty to distribute once the acknowledgment was made if the aforesaid situation is not relevant. But this situation will only be relevant if 120 days have elapsed since the acknowledgment. This is clearly an awkward formulation.

If, say, 74 days have elapsed since the acknowledgement (the 46(3) requirements will then not apply), the board is under a duty to distribute. But what if the acknowledgment turns out to be defective and/or the requirement of section 46(1)(b) is no longer satisfied, and the board is aware of this? The Act seems to say that there is nevertheless a duty on the board to complete the distribution. But this would be highly undesirable. This provision probably derives from the Model Act.³⁴⁸ In the Model Act, the 120 day rule operates solely in respect of “other distributions”. A reassessment under the Model Act is not possible in the case of a distribution of a debt or the reacquisition of shares (unique timing rules operate in these cases). Under the Model Act the rule is called for because, for “other distributions”, the test must as a general rule be applied at the time of authorisation – save if payment will occur in excess of 120 days later.³⁴⁹ Specifically, section 6.40(e)(3) states that the time for measuring the effect of a distribution for compliance with the financial restrictions for all distributions (not concerning the reacquisition of shares or the distribution of a debt) is the authorisation date, if the payment occurs within 120 days following the authorisation; if the payment occurs in excess of 120 days after the authorisation, however, the date of the payment is the relevant date. The 2008 Act, by contrast, mostly uses the time of “making” a distribution as the reference point.³⁵⁰ It should also be noted that under the Model Act – in contrast with the position under the 2008 Act – no particular resolution acknowledging or declaring an application of the financial limitations is required.³⁵¹

³⁴⁷ It is submitted that this section further justifies my interpretation of section 46(1)(c). Two things are required under section 46(3): a factual reconsideration of solvency and liquidity, as well as an acknowledgment – a substantive reassessment is required, in addition to a formal acknowledgment. Section 46(1)(c) proceeds along the same lines: a formal acknowledgment is needed, on top of a reasonable conclusion that the company will actually meet the solvency and liquidity test. In this sense, it is arguable that the inclusion of two clauses (rather than just one) in section 46(1)(c) is (purposefully) functional.

³⁴⁸ See section 6.40(e)(3).

³⁴⁹ In which case the effect of the distribution must be measured as of the date of payment.

³⁵⁰ Van der Linde “The solvency and liquidity approach in the Companies Act 2008” (2009) 2 *TSAR* 224, 238.

³⁵¹ 238.

Van der Linde correctly states that the implication of sections 46(2) and (3) is that periodic reconsiderations must be performed irrespective of when the corporation intends to proceed or continue with the distribution, once the first acknowledgment has been made.³⁵² She says that a company which does not intend to implement a “distribution within 120 days of its authorisation would thus be wise to postpone the initial adoption of the acknowledgment resolution until shortly before the intended implementation”.³⁵³ However, this solves one problem by creating a new one. It will probably subject directors to liability where they authorize a distribution knowing that they have not yet acknowledged that the liquidity and solvency test is met. Moreover, it may happen that the company will make an acknowledgement because they intend to immediately make a distribution but that unintended delays between the acknowledgement and completion of a distribution then ensue.³⁵⁴ The directors are forced to take the initiative with positive steps to evaluate the financial position of the company at regular intervals. From this perspective, then, it appears that substantive revision of the Act on this score is necessary. A reconsideration (as stipulated in section 46(3)(a)) and acknowledgment (as set out in section 46(3)(b)) should be required if, and only if, the corporation will imminently proceed with a distribution and an excess of 120 days have elapsed since the previous consideration and acknowledgement.³⁵⁵

But, as already alluded to, there is a further problem. The company *must* proceed with the distribution unless 120 days have elapsed since the acknowledgement. This is also awkwardly formulated. Essentially, the board is given 120 days to distribute (based on the first acknowledgment). The reason behind giving an acknowledgment a limited shelf life is fairly clear. The financial position of any company is not static; and the directors’ forecast of the financial position can easily change with time, as business conditions develop. In time the reasonable conclusion in an acknowledgment that the financial limitations will be met immediately after completing the distribution may no longer hold as the directors’ estimation changes over time. Section 46(3) also refers to “a fresh acknowledgment being made in terms of this subsection”. Hence, any distribution cannot legally be completed unless there is an acknowledgment which is not older than 120 days. The purpose of the requirement of the acknowledgment is naturally to ensure the board is focused on the solvency and liquidity requirement, to safeguard the interests of creditors.

³⁵² 238.

³⁵³ 238-9.

³⁵⁴ 239.

³⁵⁵ 239.

The acknowledgment is ostensibly accorded such weight that it strangely appears that the company will be obligated to carry out what would amount to an unlawful distribution simply because of the board's formal acknowledgment. This is highly problematic. Seemingly, as a result, directors would sometimes be forced to incur liability, knowing full well beforehand that they would become so liable. Van der Linde speculates that these differing standards were enacted in order to distinguish between "the validity of a distribution, on the one hand, and the liability of directors, on the other hand".³⁵⁶ The statement implies that the import of the Act will be that directors will not be liable if they distribute in these circumstances. Given this impossible or absurd situation, presumably, it is unlikely that personal liability could realistically follow. But this conclusion is of doubtful correctness. Moreover, a distribution will continue to be unlawful. It seems to be unacceptable to force a company into unlawful distributions even if directors will not incur liability.

This provision seems to apply irrespective of whether the resolution to authorize the distribution was correctly adopted or not. The board could well be placed in an impossible situation. On the one hand, it could be that if the acknowledgment is made after the authorisation, the relevant directors will incur liability as they would reasonably have to know that all the requirements of section 46 have not been met. On the other hand, if the acknowledgment is made before the authorisation, the decision to distribute could be deemed redundant, as the directors cannot go back on their acknowledgment in any case (provided 120 days have not yet elapsed since the acknowledgement). The implication is that the board can be compelled to make unlawful payments in cases where authorisation is required – under section 46(1)(a) – but has not yet been properly given.

An apparently cogent answer can be given to this last concern. No duty to distribute arises where proper authorization is not given: the directors cannot be forced to distribute unless the distribution has been authorised properly. Unless the distribution is pursuant to an existing obligation or a court order, there must be an authorisation, otherwise the distribution cannot be lawfully made – section 46(1)(a) is unequivocal about this. Even if 120 days have elapsed without an authorisation, section 46(3) need not be complied with yet (an additional

³⁵⁶ 239.

acknowledgment will not be required). A re-acknowledgment will only be needed once there has been authorisation.

The truly unfortunate consequence of the particular formulation seems to be that a company may have to proceed with and complete a distribution on the strength of the acknowledgement despite the fact that the company no longer appears to meet the financial restrictions within the 120 day period. In this sense, then, there is a striking incoherence in section 46. Sections 46(2) and (3) – read together, as the Act requires – are not consistent with the all-important objective injunction of section 46(1)(b). It is true that section 46(1)(c) obligates the board to base its acknowledgment on the financial position of the company immediately after completing the distribution, but the company could easily no longer reasonably appear to pass the test when it distributes within 120 days.

Considering the immense weight the acknowledgment carries, there should be room for reversing or retracting it if it later appears the company will not comply with the financial restrictions. However, the Act does not expressly allow for this possibility. It would perhaps be necessary to find ways to read this into the Act. Aside from the fact that no express prohibition can be found negating a reversal, several points can be made. It should be remembered that the board has to reconsider the solvency and liquidity test if 120 days have elapsed. And a (re)consideration of solvency and liquidity is routinely paired with the requirement of the acknowledgment. This is confirmed by the two clauses included in section 46(1)(c) where the acknowledgment is mentioned apart from the reasonable conclusion of solvency and liquidity; the division of parts (a) and (b) of section 46(3) backs this up as well. The implication of a reconsideration of the acknowledgement might hence not be too fanciful a stretch. It might in fact be necessary for a proper functioning of the provision. And the purpose of the relevant provisions will better be realised.

Alternatively, it might be possible that the distribution can be delayed subject to a further acknowledgment. A less likely solution lies in section 77(5) of the Act. This section reads as follows:

(5) If the board of a company has made a decision in a manner that contravened this Act, as contemplated in subsection (3) (e)—

(a) the company, or any director who has been or may be held liable in terms of subsection

(3) (e), may apply to a court for an order setting aside the decision of the board; and

(b) the court may make—

(i) an order setting aside the decision in whole or in part, absolutely or conditionally; and

(ii) any further order that is just and equitable in the circumstances, including an order—

(aa) to rectify the decision, reverse any transaction, or restore any consideration

paid or benefit received by any person in terms of the decision of the board; and

(bb) requiring the company to indemnify any director who has been or may be held

liable in terms of this section, including indemnification for the costs of the

proceedings under this subsection.

It therefore requires that the acknowledgment must have breached the Act. The real problem arises where the acknowledgement was properly made but circumstances have changed or new facts have come to light. Furthermore, the involvement of the courts in this matter is hardly the most efficient solution. Certainly this is an area where an amendment is required. Such an amendment will have to make clear that the company is not allowed to proceed with a distribution should the directors no longer be satisfied that the financial requirements will be met. The relevant shareholder should not be able to enforce her claim in these situations even though an acknowledgement has already been made. This seems to be the best way to secure the needed flexibility. The weight attached to the acknowledgment therefore must be reduced. Its function will hardly be achieved if it is utilised in the rigid manner which the Act currently envisions.³⁵⁷

With these considerations in mind – and without playing down the urgent need for an amendment in this area – it is nevertheless important to tease out the best interpretation of section 46(2) and (3) as it is currently formulated. There is a way of interpreting these provisions which tempers the peremptory character of section 46(2). The content of section 46(2) could also be that if the distribution is carried out at all, it must at least always satisfy the requirements of section 46(3). The phrase “subject only to subsection 3” in section 46(2) would then indicate that the obligation applies only if 46(3) has at least been complied with. Once an acknowledgment has been made, the distribution can only be carried out if section 46(3) is also complied with. Some of the difficulties mentioned earlier can be bypassed in this way.

³⁵⁷ Van der Linde makes the same point. She uses section 52(3) of the New Zealand Companies Act as support for her position, stating that a general prohibition is to be preferred in order to cater for the situation where a change in the financial situation of the company occurs between the time of acknowledgment and the time of implementing the distribution (239).

On this reading, where an acknowledgment has been made, and the board realises at a later time when the authorisation is to be made that all the requirements of section 46 will no longer be met, the board cannot be forced to make the distribution. And if at a later stage the board again wants to proceed with the distribution, the requirements of section 46(3) must be met. Even if both the acknowledgment and the authorisation have occurred and at the time of making the distribution, the directors realise that a requirement of the Act will not be satisfied, the board can elude the ostensible duty in section 46(2) and postpone the distribution (and the distribution can only be made subsequently, provided the requirements in section 46(3) have been satisfied).

Sections 46(2) and (3) in this way ensure the acknowledgment made under section 46(1)(c) remains relevant. Section 46(2) then makes sure that periodic acknowledgments will be made. The acknowledgment then serves the helpful function of focusing the attention of the directors on the solvency and liquidity of the company. I have touched on section 46(3) already. It can be said that this section separates the duty not to distribute without acknowledgment and the duty to acknowledge. The section essentially prescribes two requirements. It does this from two different angles. The first requirement is a reconsideration of solvency and liquidity; the second requires a new acknowledgment. But, from the one side, there is basically a duty on the board to make an acknowledgment periodically – i.e. every 120 days. From the other side, the board will only have the right or the competence to make a distribution if an acknowledgment has been made in the preceding 120 days. It should be clear that all the difficulties spelled out earlier are not fully answered by this creative interpretation.

Moreover, it should also be obvious that this interpretation is far from necessitated by the wording used. In truth, it is quite a fanciful spin on the wording. On this score, the 2008 Act thus, once more, seems to place the interpreter – especially the director – in an exceptionally invidious position. Clearly, the intuitive or literal reading of the Act here leads to absurd consequences. On any theory of interpretation, licence is granted in this event to depart from the ‘ordinary meaning’.³⁵⁸ A departure will have to proceed in a principled manner.³⁵⁹ Certainly the illocutionary intent is not apparent; the larger reason or perlocutionary intent

³⁵⁸ ‘Ordinary meaning’ is routinely what is spoken of in this context; but this betrays confusion about how language works – see chapter 2. I would argue that here, as elsewhere in the 2008 Act, the full assertion or legal content leads to absurd consequences. No workable, coherent assertion can readily be discerned.

³⁵⁹ See 2.2 above and the parameters sketched in relation to constitutive interpretation.

has been hinted at but uncertainty seems to prevail. I think the context of section 46 is perhaps the best pragmatic tool for gauging illocutionary intent. Probably, though, there is no coherent assertion here. And so a transformative – content-changing – interpretation is necessary to make the Act work in this regard. It is submitted that the fanciful interpretation outlined above falls into this category. And contextual and commonsensical factors gesturing towards this creative interpretation serve as justification for this particular interpretative choice, in the face of an incomplete or inadequate legislative assertion. Far-fetched though this interpretation may be, the ostensible duty to distribute in section 46(2) can be justifiably tempered. It appears, on a ‘normal’ reading that, once an acknowledgment has been adopted, the board is obliged to distribute.

In any event, until amendments are effected, it can certainly be said that the solvency and liquidity requirement underlies the creative interpretation proposed here: interpretative liberties are taken with a view to actualising the goal of solvency and liquidity. A pervasive objective of the Act in general and distributions in particular is honoured. From this perspective, a measure of legitimacy attaches to the espoused interpretation.³⁶⁰

Section 46(4) is the next provision which stands to be considered. However, a detailed analysis of this section has already been performed (under section 3.7 above). A few points to recapitulate and tie up loose ends: a special rule applies regarding the timing of the determination of solvency and liquidity when it comes to the incurrence of a debt or other obligation. It will be recalled that problems abound concerning this provision. Principally, not only the financial restrictions, but also all the requirements of section 46 – in addition to the board resolution – must be applied at the time the board resolves that the company may incur the debt. And this should not really be the relevant time. The time at which liability arises should be the critical time. It stands to reason that this provision applies to the decision in terms of section 46(1)(a). The position is somewhat uncertain where an obligation is created in terms of a court order or derives from another legal source. The 120 day rule of section 46(3) will not apply to distributions made in terms of section 46(4). It has been noted that the timing rules in most systems vary according to the kind of obligation incurred; on the whole it is arguable that a differentiated approach would have been preferable for better rigour and

³⁶⁰ Since the legislature’s assertion here is purportedly incomplete or inadequate, solvency and liquidity does not strictly serve the purpose of a pragmatic element filling out the assertion (as it seems to do in subtle ways elsewhere). Rather, it serves the function of *justifying* an instance of going beyond assertion.

clarity. In this case it likely would have been preferable if the solvency and liquidity test was required to be applied at the moment that the obligation is created. Undoubtedly substantial amendments are necessary to give proper content to this provision.

As section 46(6) triggers the liability provisions in connection with distributions – and thus stands to be assessed in the next chapter which specifically tackles this theme – the last provision requiring brief attention in this chapter is section 46(5), which deals with a conflicting court order. The board does not have to resolve to make the distribution when a court order is made which forces the company to acquire shares – for example, in accordance with section 163. However, an acknowledgment that the company will be solvent and liquid will still have to be adopted. The company may apply for an order varying the original order if a conclusion is reached that the company will not be solvent and liquid after making the payment. The court will make the order if it is just and equitable (having regard to the financial circumstances of the company).³⁶¹ It also will have to ensure that the recipient is paid at the earliest possible date compatible with the company satisfying its other financial obligations as they become due and payable.³⁶²

In this regard the acknowledgment once more serves its function: it will fulfil the important procedural purpose of focusing the attention of the board on the question whether it should bring a court application. The permissive “may”, and not the peremptory “must”, is used in section 46(5)(a), so that the company is not forced to apply to court.³⁶³ Noncompliance with this provision will not lead to liability, as liability flows from the director’s participation in the resolution authorising the distribution (which is absent here). It seems general remedies will, however, remain available.³⁶⁴ This provision will not apply to appraisal rights, as these are not distributions. This provision may serve an additional function. If after having adopted an acknowledgment of solvency and liquidity in the case where the board has authorized

³⁶¹ Section 46(5)(b)(i).

³⁶² Section 46(5)(b)(ii).

³⁶³ The permissive “may” follows in section 46(5)(b) but a different meaning is conveyed here. The requirements in (i) and (ii) are not optional. It is just that subsection (b) sets out the limits of the court’s competence in this regard.

³⁶⁴ Two legal pronouncements or injunctions conflict here: a court order prescribing a distribution, and the legal requirement that a distribution must not be made if the financial limitations will not be complied with. According to section 46(5) the company is not obliged to apply to the court for a variation of the original order. It is submitted, however, that a contravention of section 46(1)(b) would nevertheless render the distribution unlawful. General liability provisions such as section 218(2) can still be utilised. In the event that an application is brought pursuant to section 46(5), this fact will have to be carefully weighed. The court will have a fairly expansive discretion to strike the appropriate balance.

distribution in terms of s 46(1)(a)(ii), it later appears that the solvency and liquidity test will no longer be met, the company could perhaps utilise this provision. But this will have to be a consideration of solvency and liquidity as required “by this section”.³⁶⁵ And, as has been pointed out, the Act is strikingly quiet concerning this possibility and so it is questionable whether this qualification will be met. Lastly, there appears to be no reason why shareholders and the company cannot agree to postpone a distribution. But again, the Act says nothing about this.

4.3 Conclusion

There is no necessary conceptual connection between distributions on the one hand, and solvency and liquidity on the other. But the 2008 Act specifically adopts a solvency and liquidity approach as a restriction on distributions. The way in which the financial restrictions have been newly devised necessarily informs the construction of the law on distributions. The interplay and interdependence between solvency and liquidity, the authorisation of the distribution and acknowledgment of solvency and liquidity, and (tangentially) directorial liability has been evidenced in this chapter (in addition to other drafting problems). It has been shown that the relationship between the first three issues has not been coherently conceived in the 2008 Act. Many of the problems and inconsistencies will necessarily be carried over into the domain of the directorial liability for unlawful distributions. A consideration of the liability of directors for unlawful distributions, to be tackled next (together with incidental issues), thus completes the picture. The stage will then be set for appropriate reform proposals.

³⁶⁵ Section 46(5) introductory line.

Chapter 5

Directorial Liability for an Unlawful Distribution and Related Issues

5.1 Introduction

The 2008 Act takes a positive step away from the regime under the 1973 Act by making directors potentially liable, not only for unlawful repurchases, but also for unlawful distributions. Shareholder liability for receiving unlawful distributions, by contrast, is not covered by the 2008 Act.

Van der Linde states that the Act regulates directorial liability “in a coherent fashion”.³⁶⁶ It will become clear throughout this chapter that this statement is not entirely true. Similar anomalies and uncertainties emerge here as in the previous chapters, again owing to poor drafting. It will be seen that often, due to the interdependence of the broad themes under consideration in this thesis, conceptual problems in one area have a knock-on effect elsewhere. In piecing together the relevant elements at play in the law on distributions, and ending in directorial liability, it also becomes clear that the structure of the 2008 Act is chaotic and confusing. Discerning the full picture necessitates jumping from one part of the Act to another. The liability provisions are set out in section 77, whereas distributions are dealt with (mainly) in section 46; and it has also become clear that other provisions scattered throughout the Act can also have an impact.

The pervasive influence of the new solvency and liquidity philosophy manifests also with regard to the liability of directors for unlawful distributions. Significantly, a director can only incur liability for non-compliance with the financial requirements (even though sections 46(6) and section 77(3)(e)(vi) refer to a distribution contrary to section 46 generally). Moreover, the Act imposes an important limitation on the liability of a director for an unlawful distribution, by stipulating that liability will only ensue if the company in fact turns out to be insolvent or illiquid subsequent to the making of the distribution.³⁶⁷

³⁶⁶ Van der Linde “The regulation of distributions” (2009) *TSAR* 495.

³⁶⁷ Section 77(4)(a)(i).

The requirements, limitations, and scope of the liability of directors is analysed below; I also briefly consider the issue of shareholder liability, after which the chapter ends in a concluding remark.

5.2 Directorial Liability

Section 77 of the 2008 Act caters for the liability of directors and prescribed officers. Directorial liability for distributions made in violation of section 46 is regulated by section 46(6) in conjunction with section 77(3)(e)(vi).³⁶⁸ In the context of the liability provision, the term “director” bears a broader meaning, which encompasses an alternate director, prescribed officer and a member of a board- or audit committee (regardless of whether the person in question is also a member of the board of directors of the company).³⁶⁹ But this is yet another instance of a lack of precise and thoughtful drafting. Having regard to the specific provisions relating to liability for distributions (and repurchases), it appears that only directors in the narrow sense can be held liable, because of the requirement that the director must have participated in the board resolution authorising the distribution (see below).

A director will be liable jointly and severally with any other director who is liable for the same act. It seems that only other directors and officers can incur liability for the same act. The implication is that the director or officer will not incur liability jointly and severally with shareholders who received the distribution, because their liability is not contingent on the same act – directors will be held liable exclusively for the balance not recovered from shareholders.³⁷⁰ It is likely better that creditors and shareholders should not be permitted to claim against the directors, as a general rule. The company is the appropriate claimant.³⁷¹ However, the novel statutory derivative action should not be forgotten in this regard: section 165(2)(d) allows creditors to claim on behalf of the company with the court’s consent. In terms of subsections (a) and (b), shareholders and co-creditors can also enforce the company’s right of recovery.

³⁶⁸ Section 48(7) read with section 77(3)(e)(vii) addresses liability with regard to an acquisition of shares in violation of sections 46 and 48.

³⁶⁹ Section 77(1).

³⁷⁰ Section 77(4)(b)(ii). See 496 (footnote 106).

³⁷¹ Van der Linde notes that this position accords with most comparable jurisdictions. California is a striking exception: section 316(c) of the California Corporations Code explicitly affords shareholders and creditors a general right to enforce the liability of directors with regard to unlawful distributions.

5.3 The Requirements for Liability

Putting aside, for the moment, the limitations of liability (discussed in the next section), there are essentially two requirements for directorial liability for an unlawful distribution. The first is that the director must either have been present at a meeting where the board approved the distribution or must otherwise have participated in the making of the decision.³⁷² The requirement of having to be present and to vote is perhaps not proactive enough. Maybe directors should bear a duty to contribute to creditor protection more generally. Under section 74, board resolutions can be adopted otherwise than at a meeting if it is taken by a majority of the directors (either by written consent in person or via electronic communication if all the directors received notice of the matter to be decided). Ostensibly, a director will have participated in the making of a decision where she had been notified of a matter to be decided otherwise than at a meeting, but this is not necessarily so. Departures from section 74 are seemingly permissible; but the prospective impact of such departures on the functioning of section 46 is still unclear.³⁷³

Quite crucially, from the cross-references in sections 46(6) and 77(3)(e)(vi) to the term “approval”, it appears that liability hinges on the director’s participation in the resolution *authorising* the distribution – and not the resolution acknowledging the application of the solvency and liquidity test. The second part of section 46(6) refers to the term “decision”. But this is merely to link it to the section 74 procedure. And it is clear that “such a decision” refers to the approval or authorisation. Van der Linde agrees that this is what the legislature asserted (even though she thinks this was a mistake).³⁷⁴ I do not think it can be doubted that the legislature here asserts that liability depends on the authorisation (as opposed to the acknowledgement of solvency and liquidity).

This will have curious effects, however. A director who merely participated in the acknowledgement and wrongly concluded that the solvency and liquidity requirement will be met will escape liability where she does not also participate in the authorisation of the distribution. This will also apply where only an acknowledgment is required. Conversely, a

³⁷² See section 46(6)(a) and section 77(3)(e) in conjunction with section 74.

³⁷³ It appears that departures are only permissible in the direction of stricter requirements, e.g. only a physical meeting will suffice.

³⁷⁴ 496. She says that, even if the acknowledgment is actually what was meant here, it is evident that this resolution will also have to deal with the predicted financial situation upon completion of the entire distribution.

director who took part in the authorisation but played no part in the acknowledgment could incur liability in spite of not participating in the acknowledgement, if she knew the acknowledgment was not correctly made. Furthermore, liability cannot be imposed in terms of section 77(3)(e)(vi) with regard to distributions pursuant to a court order or an existing legal obligation, despite the fact that these are subject to the solvency and liquidity requirement.³⁷⁵

These instances may well lead to an accountability gap; it is clear that this arrangement has not been cogently devised. It should be remembered, though, that a director can nonetheless be held liable for breaching her duty of care and skill under a broader liability section.³⁷⁶ More directly, a possible solution might be to base liability instead on an unreasonable acknowledgment regarding the satisfaction of the solvency and liquidity test. This is what Van der Linde proposes.³⁷⁷ But, until such time as proper amendments can be effected, an attempt has to be made to gauge the content of the law as it is.

An attempt must be made to establish a logical relationship between the relevant provisions. Section 46(1)(b), *inter alia*, affects the *validity* of the distribution: non-compliance with this section would render the distribution unlawful (even if all the other requirements have been met and even where no directors are liable). Non-compliance with this section, that is to say, is a necessary and sufficient condition for the invalidity of the distribution. Additionally, a director will be liable if he voted against the decision to participate knowing that section 46(1)(b) was not complied with (knowing that the company will not be solvent and liquid after completing the distribution). Liability with respect to section 46(6), in other words, can also flow from section 46(1)(b).

The relationship between section 46(1)(c) and liability in terms of section 46(6) is more difficult to establish. Notably, a director's knowledge in respect of compliance with section 46(1)(b) says nothing about her participation in a section 46(1)(c) acknowledgment. But the acknowledgment may yet have probative value: there is a chance that it can show that the solvency and liquidity of the company was generally accepted. Where the director participates in the acknowledgement, it will likely be more difficult to show that she was

³⁷⁵ 496.

³⁷⁶ 497.

³⁷⁷ 496.

unaware of non-compliance with section 46(1)(b). But again, all of this presupposes that the acknowledgment precedes the authorisation.³⁷⁸

Of course, the mere participation of a director in the acknowledgment cannot be said to constitute conclusive evidence of her mental state. An application of the solvency and liquidity test operates on a prediction of the financial position of the company in the future. An acknowledgment might be made at a time when it would be reasonable to suppose the company will be solvent and liquid at the critical time. And a director, as I have said, could be held liable at the time of the subsequent authorisation should it appear the company will no longer satisfy the test at the critical time – i.e. perhaps it is no longer reasonable at this later stage to think the company will satisfy the financial restrictions at the critical moment. This reasonableness element figures in the limitations of liability which I consider in the next section.

The second requirement is that the director must have failed to vote against a resolution approving a distribution despite knowing that it is contrary to section 46.³⁷⁹ This applies equally to a meeting and a decision taken otherwise than at a meeting. A director who fails to register her dissent concerning a decision taken otherwise than at a meeting will also incur liability.³⁸⁰ The knowledge entailed in “knowing” is quite expansive. It does not only denote actual knowledge. In addition, a director will be regarded as “knowing” something if she is in a position where she reasonably ought to have had actual knowledge, or to have investigated the matter to an extent that could have provided her with actual knowledge, or to have taken measures which, if taken, could reasonably be expected to have supplied her with actual knowledge of the matter in question.³⁸¹

5.4 Limitations of Liability

Section 77(4)(a) limits the liability which directors may incur under section 46(6) read with section 77(3)(e)(vi). In other words, two additional preconditions for directorial liability (over and above the section 46 requirements for liability) have been enacted. First, the company

³⁷⁸ See 4.2 above: As I have said, this is not specifically required. But it is arguable that it should, on pain of violating the Act. That is, otherwise the board will be authorising a distribution knowing that all the requirements of the Act have not yet been met – i.e. the acknowledgment is plainly a requirement of the Act.

³⁷⁹ Section 46(6)(b) read with section 77(3)(e)(vi) of the 2008 Act.

³⁸⁰ 497.

³⁸¹ Section 1, definition of “knowing, knowingly or knows”.

should not have satisfied the solvency and liquidity test immediately after making all of the distribution.³⁸² In effect, as a prerequisite for directorial liability, an objective *ex post facto* solvency and liquidity test is imposed.³⁸³ The resultant reality of solvency and liquidity thus trumps the inaccurate prediction of solvency and liquidity, as far as directorial liability is concerned. This will be so irrespective of whether the prediction was reasonable or unreasonable. It would not make sense to hold directors liable for an incorrect prediction of solvency and liquidity if the company in any event turns out to be solvent and liquid when the distribution was made – and so this constitutes a vital limitation of liability.³⁸⁴

This base requirement also make clear that exclusively a breach of the financial limitations can lead to directorial liability – despite the references in section 46(6) and section 77(3)(e)(vi) to a distribution in violation of section 46 as a whole.³⁸⁵ As a result, non-compliance with any of the other requirements will have to be covered by the general liability rules of the 2008 Act³⁸⁶

At the same time, it appears liability cannot arise with regard to a partial implementation of a distribution in contravention of the solvency and liquidity requirement. This is because there must be non-compliance with the test after making “all” of the distribution set out in the resolution. It is not self-evident why this is necessary. This also creates dissonance with section 46(1)(b): here it is simply stated that the company has to satisfy the financial requirements “after completing the proposed distribution”. The Act also does not address the situation where the company suffers a loss as a result of an improper distribution without, however, becoming illiquid or insolvent. The company could attempt a claim for damages under section 218(2) in these situations.³⁸⁷

The second limitation of liability in terms of section 77(3)(e)(vi) is that it must have been unreasonable at the time of the decision to conclude that the company would satisfy the

³⁸² Section 77(4)(a)(i).

³⁸³ 497.

³⁸⁴ 497.

³⁸⁵ See section 46(6)(b): “contrary to this section”.

³⁸⁶ 497-8. See sections 75 to 75 of the 2008 Act.

³⁸⁷ Though the section is (extremely) broadly worded, a specific shareholder will likely not succeed in bringing such a claim. Section 218(3) states that all other rights “a person” may have are unaffected by this section. On the back of this, as well as the manifest open-endedness of sub-section (2), it would not appear as though section 46 (in conjunction with the liability provisions of section 77) and section 218 are mutually exclusive. A cogent case can thus theoretically be made here in reliance on section 218(2). However, where liability is explicitly delineated (as here), a reliance on section 218(2) is probably bound to fail.

solvency and liquidity test after making the relevant distribution.³⁸⁸ Though at first blush it appears a prudent limitation, it is not without problems. Suppose, pursuant to section 46(6), a director fails to vote against a distribution even though she reasonably should have known the company will not satisfy the financial requirements. Such director can nevertheless escape liability if she can prove it was reasonable at the time of the decision to think that the requirements would be satisfied. Is it consistent to maintain that one can act reasonably for this purpose and yet not be reasonable enough to foresee non-compliance or to acquire the relevant knowledge in the first place? Whilst probably not conceptually incoherent, the practicability of the limitation is certainly open to question.³⁸⁹

Again, the reason for the use of the term “decision” instead of “resolution” is unclear. In section 46(6) it is quite clear that the use of the word there refers to the authorisation of the distribution. Even though the legislature forces a reader of the Act to jump around quite a lot, these scattered provisions are intended to be read together. On the face of it, it is probably plausible, therefore, to assume that “decision” in section 77(3)(e)(vi) is co-extensive with the authorisation or decision to distribute.

Van der Linde takes a different line. She tentatively suggests that the different wording is intentional: that the legislature means to refer to the resolution acknowledging the application of the solvency and liquidity test, not the authorisation.³⁹⁰ She thinks the context supports this conclusion: the directors “are only required to consider the solvency and liquidity test when making that acknowledgment”.³⁹¹ This is surely mistaken. True, only in section 46(1)(c) – the part dealing with the acknowledgment requirement – does the legislature explicitly require *the board* to consider solvency and liquidity.³⁹² But, as is abundantly clear from the foregoing analysis, the time of adopting the acknowledgment will not be the only time that the board has to consider solvency and liquidity.³⁹³

³⁸⁸ Section 77(4)(a)(ii).

³⁸⁹ A distinct construal of ‘reasonableness’ might attach to each of these provisions, rendering it conceptually coherent. Something analogous appears in the law of delict, where the ‘reasonable foreseeability’ of fault (negligence) is separated from the objective (overall) reasonableness contained in the concept of wrongfulness.

³⁹⁰ 497.

³⁹¹ 497.

³⁹² See 4.2 above.

³⁹³ See 4.2 above.

As I have pointed out, there may easily be a time lag between the acknowledgment and the authorisation; and the Act seems to have hung liability on the hook of the authorisation, not the acknowledgment. A consideration of solvency and liquidity will thus no doubt be relevant to the board at the time of the authorisation as well. Van der Linde's contention is likely borne out by her interpretation of section 46(2) and the potentially limited effect that section 46(1)(b) would then have.³⁹⁴ However, Van der Linde's contention contradicts another of her suggestions. Elsewhere, she says a company should be prohibited from proceeding with a distribution where the directors are no longer satisfied that the company will meet the solvency and liquidity test – a proposition I agree with. But, of course, this implies that the board *again* considers the financial requirements – i.e. after the acknowledgment has been made. Van der Linde is thus wrong to state that the directors are only compelled to consider the financial requirements when making the acknowledgment.

Van der Linde may well have conflated her prescriptive suggestions with what the Act descriptively (actually) asserts. These are two very different things and are best kept apart. A sizeable part of my endeavour in this thesis is to tease out the limits of the descriptive task of discerning the law as it is. Where the law creates undesirable effects, or is hopelessly inefficient or otherwise problematic, substantive proposals for reform are necessary; but these proposed improvements are not, it is worth emphasising, the law as it stands. Probably, Van der Linde, in this particular interpretative quandary, is trying to link up her interpretation of the word “decision” to her prescriptive proposal that directorial liability should be contingent, not on the authorisation, but the acknowledgment.³⁹⁵

In the light of this confusion, I would obviously suggest an improvement in the wording, making it clear whether the authorisation or acknowledgment is intended. As is clear, this choice will have to be consistent with the basis of liability: if liability hinges on the authorisation, then that should be what is relevant here as well. If liability turns on the acknowledgment, then this declaration is the relevant point in time. The proposal I make in the next chapter will endeavour to take account of these considerations.

³⁹⁴ See 4.2 above.

³⁹⁵ See 4.2 above. In her defence, she does say that the law currently attaches liability to the authorisation (even though she deems this a bad idea) (496).

My view is that liability must hinge on the director's conduct in relation to the satisfaction of the solvency and liquidity requirement. Given all the problems surrounding the tripartite relationship between section 46(1)(a), (b), and (c), the 2008 Act does not offer a clear and coherent basis for directorial liability.³⁹⁶ The unsophisticated use and confusion of the authorisation and acknowledgment necessarily muddies the waters of directorial liability. In most comparable jurisdictions, the prerequisites for the liability of directors are clearer. In England, California, under the Model Act, as well as in New Zealand, liability is structured around directorial conduct in regard to the financial requirements. The 2008 Act's link between directorial conduct and the financial restrictions is tenuous and unclear as a result of the confusion between the authorisation and the acknowledgment. Now it is clear that the 2008 Act has introduced the requirement of a solvency declaration on the part of the directors in the form of an acknowledgment. It is not indispensable that a particular system makes use of such a declaration but there is nothing wrong with it in principle.³⁹⁷ I therefore do not propose doing away with the acknowledgment.³⁹⁸ It is just that the myriad difficulties attaching to it in the 2008 Act – particularly its relation to the authorisation – will need to be remedied.

Notwithstanding the uncertainties created by the wording, the introduction of this (second) limitation, in my view, carries merit. The requirement softens the objective solvency and liquidity standard. In spite of actual insolvency or illiquidity, if the directors acted reasonably when making the relevant decision, they will nonetheless escape liability. So, a reasonableness standard, serves as a fundamental precondition for liability. Nevertheless, it will be difficult to determine the exact relationship between this restriction and s 46(6), which requires that a director will become liable only if he knew or reasonably should have known that a requirement of s 46(1) was not met. The reasonableness element in both these provisions overlaps in a complicated manner. Overall, a reasonableness requirement remains an appropriate limitation and the maintenance of this principle will be reflected in the proposals I advance in the next chapter.

5.5 Scope of Liability

³⁹⁶ See 4.2 above.

³⁹⁷ In fact, I pointed out above that it indeed has some utility.

³⁹⁸ A similar mechanism can be found in England and New Zealand, for example.

According to section 77(3)(e), a director is liable for any loss, damage, or costs sustained by the company as a direct or indirect result of the director's conduct. The section goes on to enumerate various instances which can result in liability, including unlawful distributions.³⁹⁹ The crux is that section 77(4)(b) restricts the liability that can be imposed under 77(3)(e)(vi) with regard to distributions in contravention of section 46 to:

the difference between—

- (i) the amount by which the value of the distribution exceeded the amount that could have been distributed without causing the company to fail to satisfy the solvency and liquidity test; and
- (ii) the amount, if any, recovered by the company from persons to whom the distribution was made.⁴⁰⁰

In other words, liability may not exceed the amount by which the distribution goes beyond solvency and liquidity.⁴⁰¹

5.6 The Liability of Shareholders

As I have mentioned, the 2008 Act fails to deal explicitly with the issue of shareholder liability with respect to unlawful distributions.⁴⁰² This is regrettable and also rather curious, as the previous act under sections 90(4), 86(2) and 86(3) did in fact regulate the issue. It is uncontroversial that the common-law rules have to plug the gap.⁴⁰³ In other words, in light of the absence of particular statutorily regulated liability as regards the receipt of unlawful

³⁹⁹ Section 77(3)(e)(vi).

⁴⁰⁰ Section 77(4)(b).

⁴⁰¹ In the case of an acquisition of shares, knowledge of the violation of either section 46 or section 48 is required for liability. Van der Linde notes that the scope of liability will differ in the case of an acquisition of shares. In the case of section 77(3)(e)(vii), the limitation of the extent of liability will not apply even if the only defect in the acquisition was that the payment contravened the financial limitations (499). It thus becomes clear that directors involved in an acquisition of shares in contravention of the financial requirements are potentially exposed to wider liability in terms of section 77(3)(e)(vii) than directors who are held liable for an unlawful distribution. And because payment in respect of an acquisition is tantamount to a distribution, it seems this consequence was not intended. Van der Linde proposes that this undesirable effect can be overcome by removing the reference to section 46, not only from paragraph (vii) of section 77(3)(e), but also from section 48 (499).

⁴⁰² Even though, under the directorial liability provisions, there is a reference to amounts recovered from shareholders who received distributions (see section 77(4)(b)(ii)). In that sense the Act recognises the concept of shareholder liability.

⁴⁰³ Jooste, however, strangely seems to think the company cannot recover payments distributed in contravention of section 46 and section 48 ("The maintenance of capital and the Companies Bill 2007" (2007) 124 *SALJ* 715, 732). He appears to think this because the 1973 Act specifically and categorically allowed it. He thus views the 2008 Act's omission of the issue as conscious and intentional. The better view is that the common law regulates the situation. The references to shareholder liability in section 77(4) and section 48(6) confirm this.

distributions, a claim for recovery will be rooted in the common law. Most likely, then, the basis for the recovery of an unlawful distribution would be invalidity or voidness. Invalidity could spring, not only from a failure to comply with the financial restrictions, but from non-compliance with any of the requirements.

Directors are not afforded direct rights of action against shareholders (even though the ambit of their liability hinges on the amounts recovered from shareholders).⁴⁰⁴ The possibility of the statutory derivative action, however, remains open to directors.⁴⁰⁵ It appears that creditors too, with the consent of the court, can bring derivative actions. This is not stated explicitly, but naturally a creditor can be a “person” who needs to protect a legal interest of the company. The court can only grant the action if it is satisfied that it is necessary or expedient to do so in order to protect the legal right of the creditor in question.⁴⁰⁶ Essentially, the company could have a claim against a director in terms of section 46(6) or against a shareholder for the return of a distribution made to her. But it seems either a shareholder or a creditor with the consent of the court could bring these actions on behalf of the company on the grounds of section 165(2).

Ostensibly, shareholders will incur liability irrespective of whether they received the unlawful distribution in good faith or with knowledge of the illegality. Intuitively, it might seem that lack of knowledge or receipt in good faith should be a legitimate defence to shareholders. This impulse is more or less confirmed by reference to comparable jurisdictions. Van der Linde notes that shareholders are exempted from liability on the strength of ignorance of unlawfulness or good faith in the United States of America (generally speaking), in California specifically, and in New Zealand.⁴⁰⁷ A similar approach applies in England as well, as knowledge of illegality is a prerequisite for shareholder liability.⁴⁰⁸ One’s stance on the issue in the final analysis depends on a policy decision either

⁴⁰⁴ Under the 1973 Act, on the other hand, in regard to share acquisitions directors could institute direct proceedings for recovery. The dissonance on this score between the old and the 2008 Act is not a huge concern, according to Van der Linde, who maintains that the amounts can be recovered through the company (Van der Linde “The regulation of distributions” (2009) *TSAR* 495, 499).

⁴⁰⁵ Shareholders, registered trade unions, and any other person with the permission of the court can institute this action in order to protect the legal interests of the company (see section 165(2)).

⁴⁰⁶ Section 165(2)(d).

⁴⁰⁷ It is crucial to add, as Van der Linde does, that, in respect of America, the effect of the Uniform Fraudulent Transfer Act – which gives a creditor a right of recovery against a shareholder if the distribution left the company insolvent or with an unreasonably small amount of capital – counterbalances this relatively more liberal or lenient treatment in the corporate legislation (500).

⁴⁰⁸ Section 76 of the UK Insolvency Act.

in favour of shareholders or creditors. Probably, protecting the good faith of the shareholder leads to the shareholder being privileged over the corporate creditors.⁴⁰⁹ Van der Linde regards this as unacceptable and so is happy with the current state of the law. She says this is the simplest solution; that is, to hold shareholders liable regardless of whether or not they received a distribution in good faith. She contends that any practical difficulties in enforcing the recovery – the disruption which would result if recovery is sought from many anonymous shareholders of listed shares, the duplicate liability of directors, the potential invocation of insolvency law mechanisms to impeach unlawful distributions, etc – should not hamper the fundamental principle that corporate creditors should in the final analysis come first regarding the repayment of their debts.⁴¹⁰ Though I agree with the current legal position and Van der Linde's analysis, it would be desirable if the 2008 Act expressly regulates the matter, rather than leaving it to the common law.

It should not be forgotten that a different threshold for reclaiming a distribution could apply if the domain of insolvency law is entered. Although a distribution might not contravene any of the section 46 requirements, it may nevertheless be legally reclaimed, should the distribution constitute a voidable preference under insolvency law.⁴¹¹

5.7 Conclusion

This chapter has shown that the conceptual confusions with respect to the authorisation and the acknowledgment carry over into the crucial area of directorial liability. An effort has been made, descriptively (in the main), to make sense of the Act as it stands. Tentative suggestions have also been made to illustrate the possible shape which prescriptive reform proposals should take. It has also been stressed that descriptive interpretation should be kept apart from prescriptive or normative interpretative improvements. The interdependence of solvency and liquidity, the requirements for distributions, and the liability of directors is now clear. Conceptual confusion in one area has a knock-on effect in another.

This chapter, like the previous, has cautiously attempted to delineate the boundaries of creative interpretation – i.e. creative interpretation which remains within the confines of

⁴⁰⁹ See Blackman *et al* *I Commentary on the Companies Act* (2003) 5-77.

⁴¹⁰ 500.

⁴¹¹ Insolvency Act 24 of 1936, section 29.

legitimate and authoritative law-making. It has been evident that efficiency, coherence and good sense in certain cases require a measure of normative improvement to the text of the 2008 Act. Other concrete pragmatic tools – such as the purposes of the Act – are hard to come by, it was found. Content-altering interpretations will always have to proceed along principled criteria; they cannot remain unjustified.

The preceding analysis again confirms how regrettable it is that the 2008 Act has not been accompanied by a comprehensive explanatory memorandum or commentary explaining each provision of the 2008 Act. Something along these lines can be found in the Model Act, which ironically is an important influence and reference point for the 2008 Act. Had an elaborate memorandum or commentary been included, striking mistakes and inconsistencies would almost certainly not have made their way into the 2008 Act. A concomitant commentary spelling out the operation and rationale of the provisions could also have served an instrumental pedagogical role for directors, shareholders, creditors, and the general public. In keeping with this spirit, I will attempt to explain the provisions I propose in the next chapter.

Chapter 6

Proposals for Reform

In this thesis, I have identified various conceptual and terminological problems with the regulation of distributions under the 2008 Act. I have suggested ways in which an interpreter should make sense of the Act *as it is*. But it can also be said that there is a way the Act *should be*. What precisely colours this ‘should’ is an anomalous matter. But I suggest a few guidelines. And this in turn then constitutes the foundation for the (prescriptive) proposed provisions. First, often the idea or broad intention behind a provision is apparent enough; it is just that the wording fails to capture it. An attempt will be made to stay close to the larger rationale or broader purpose, where the rationale or purpose is sound. Insofar as is possible, the terminology of the 2008 Act is used. Generally the aim is as much uniformity as possible with the current provisions but it will be seen that some breaks are necessary. Certain key legislative decisions are of course left intact.

From the previous chapters, it is clear that the concept “distribution” has to be rigorously and coherently defined. It is also clear (and laudable that the 2008 Act requires) that all distributions should be subject to compliance with a solvency and liquidity test. Moreover, the requirements and mechanics of the solvency and liquidity test should also be coherently and comprehensibly set out. The preferential liquidation rights of shareholders should be deemed liabilities whenever distributions are made to classes that are of a lower rank.

Furthermore, I have criticised, not only the content, but also the structure of the relevant provisions of the 2008 Act, asserting that the Act necessitates jumping from one part to another in order to gauge the legal position concerning distributions – at the very least, section 1, section 4, and section 46 have to be consulted. But section 77 and certain rules deriving from the common law, for instance, can also often be relevant. This comprises a highly disjointed regulatory scheme. A fairly large-scale structural overhaul would likely be desirable, to make the Act read more easily.⁴¹² For this reason, I do not number the provisions (i.e. to fit into the 2008 Act as it stands). This also means that cross-referencing between sections is not possible. Nevertheless, the provisions I propose below are devised to fit into the overall framework of the 2008 Act.

⁴¹² I think the way in which the Model Act tackles the issue makes a lot more sense; it no doubt reads more easily.

Definition of the concept ‘Distribution’⁴¹³

“distribution” means a direct or indirect –

(a) transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of one or more holders of any of the shares of that company in respect of his or her shareholding, whether –

(i) in the form of a dividend;

(ii) as a payment in lieu of capitalisation share;

(iii) as consideration for the acquisition by the company of any of its shares.

(b) incurrence of indebtedness by a company for the benefit of one or more holders of any of the shares of that company in respect of his or her shareholding; or

(c) forgiveness or waiver by a company of a debt or other obligation owed to the company in respect of his or her shareholding,

but does not include any such action taken upon the final liquidation of the company.

It is thus recommended that the 2008 Act should have an elaborate definition of the concept of distribution. The drafters of the 2008 Act indeed introduced a comprehensive definition of what constitutes a distribution.⁴¹⁴ The above formulation continues in the vein of the current definition in the 2008 Act but simplifies it somewhat. The three main types of distribution are kept intact and liquidation distributions are excluded. The inclusion of paragraph (c), as contained in the 2008 Act, builds on the types of distributions found in comparable jurisdictions. Though I have been largely critical of the 2008 Act, it has to be said that manifest improvements on the 1973 Act are also not hard to find. The inclusion of paragraph

⁴¹³ See 1.2.3 above for a discussion of and comparison with the current position.

⁴¹⁴ The 1973 Act’s regulation of distributions was fragmentary; no inclusive definition of distribution was to be found.

(c) usefully covers the waiver of a claim for outstanding consideration on unpaid or partly paid shares.

Often different shareholder authorisation requirements are set, depending on whether a transfer constitutes a dividend or not. But since the 2008 Act does not require shareholder approval for *any* type of distribution, essentially nothing hinges on whether a transfer is capable of being classified under a dividend, or one of the other mentioned examples.⁴¹⁵ The idea of an expansive group dimension has been done away with. The word “indirectly” in the introductory clause is regarded as wide enough to include distributions by a company to shareholders of other companies in the group.⁴¹⁶ The acquisition of shares by a subsidiary in its holding company can certainly have the effect of a distribution. But this should be dealt with separately. This way it will be clearer to gauge how the requirements should apply particularly to these distributions. Appraisal payments should also be deemed distributions. The proposed definition will be wide enough to include such payments. Though a share repurchase should be regarded as a distribution and so has to be subject to the requirements for distributions, there should be a separate definition of an ‘acquisition’; and additional requirements for acquisitions have to be set out elsewhere.⁴¹⁷

The Making of Distributions⁴¹⁸

The 2008 Act is especially confusing because of the obscure relationship between the authorisation of a distribution, and the acknowledgment of the application of the solvency and liquidity test. How does the decision to distribute, the authorisation, the acknowledgment, the actual making of the distribution, the validity of the distribution, etc., fit together? These elements can be efficiently and coherently conceived in a number of ways. My approach is, where possible, to stick closely to the language of the 2008 Act. However, this is a domain in which essentially the whole scheme is poorly conceived. What follows is, I think, a simpler way of devising the various elements – but it is far from the only way of dealing with the issue.

⁴¹⁵ However, the memorandum of incorporation can of course still impose special requirements for dividends as compared with other distributions.

⁴¹⁶ The regulation of distributions in the group context, apart from distributions by a subsidiary to its own shareholders, should be limited to cases where a subsidiary makes a distribution to the shareholders of its holding company. The test should be met by both the holding company and the subsidiary.

⁴¹⁷ As I have previously stated, the topic of share repurchases is not considered in this thesis.

⁴¹⁸ See the discussion in 4.2 above for a comparison and critical commentary of the present state of the law.

(1) A company must not make any proposed distribution unless –

(a) it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; and

(b) the board of the company reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution, and acknowledged by resolution that it has applied the solvency and liquidity test.

(2) If 120 business days have elapsed since an acknowledgment, as required in subsection 1(b), the company may not proceed with the distribution, unless the board has reconsidered the solvency and liquidity test in respect of the intended implementation of the initial resolution, order or obligation; and has reasonably concluded that the company will satisfy the solvency and liquidity test immediately after the proposed implementation, and has acknowledged by resolution that it has applied the solvency and liquidity test.

(3) If, after having adopted an acknowledgment resolution contemplated in subsection 1(b), the board is no longer satisfied that the company will satisfy the solvency and liquidity test, it shall retract the resolution and not proceed with the distribution.

It is the making, not the authorisation, of distributions which has to adhere to the solvency and liquidity test. It will likely aid clarity to abandon the requirement of explicit board authorisation.⁴¹⁹ The decision to make a distribution is nonetheless kept apart from the question of the ultimate validity of the actual distribution. These provisions are relatively self-explanatory and largely emulate the 2008 Act. Section 1(a) is again obviously an objective test. The company has to take into account objectively determinable facts. On the other hand, section 1(b) implies a hybrid test – it is an objective test with subjective factors. The reasonable conclusion is from the perspective of the particular board in question. On the

⁴¹⁹ Van der Linde also favours an abandonment of the authorisation (Van der Linde *Aspects of the regulation of share capital and distributions to shareholders* LLD dissertation UNISA (2008) 567). But she insists on a distinction between the validity of distributions and the decision to distribute (566). It seems difficult to untangle the decision to distribute from the authorisation under the 2008 Act. I think matters can be simplified by doing away with the requirement of the authorisation.

one hand, an objective assessment of the particular facts is called for; “reasonableness” suggests a measure of objectivity. On the other hand, the “reasonableness” of the conclusions arrived at will have to hinge on information reasonably available to or known by the relevant board; the particularity of the board in question thus enters the fray. I have left out a section 46(2)-type section, given all the problems associated with this curious provision. The possibility of a retraction of the acknowledgment is also included.

It will also be necessary to set the effective date of a distribution so that the time for the application of the solvency and liquidity test (as well as the enforceability of the distribution) is fixed.⁴²⁰

Effective Date of a Distribution

- (1) If a distribution takes the form of a transfer of money or assets, as contemplated in paragraph (a) of the definition of “distribution”, its effective date is the date of actual transfer of the money or assets.⁴²¹*
- (2) If a distribution takes the form of an incurrance of indebtedness, as contemplated in paragraph (b) of the definition of “distribution”, its effective date is the date of incurrance of the debt.*
- (3) If a distribution takes the form of the forgiveness or waiver of a debt or obligation, as contemplated in paragraph (c) of the definition of “distribution”, its effective date is the date on which the liability of the shareholder is extinguished.⁴²²*

In particular, the problematic aspects surrounding the timing for paragraph (b) distributions are alleviated by this provision.⁴²³

The Solvency and Liquidity Test⁴²⁴

⁴²⁰ This is also what Van der Linde proposes (568).

⁴²¹ Van der Linde *Aspects* 568.

⁴²² 568.

⁴²³ See especially my discussion under chapter 3, section 3.7 above.

⁴²⁴ See chapter 3 for a comprehensive discussion of the solvency and liquidity requirement.

The solvency and liquidity test is a suitable and modern yardstick for protecting the interests of creditors in the context of distributions. The acknowledgment of solvency and liquidity is a welcome positive or pro-active step which directors are forced to take. As long as the acknowledgment is not deemed the ultimate determinant of the enforceability of the distribution, the imposition of a positive duty on directors in respect of the resolution acknowledging the application of the solvency and liquidity test is desirable.

In terms of the 2008 Act, the lawfulness or validity of a distribution is contingent, not on actual solvency and liquidity, but on the reasonably foreseeable financial situation of the company.⁴²⁵ On the contrary, the validity of a distribution should hinge on whether the company actually meets the solvency and liquidity test when it makes the distribution. If the test is failed, the distribution should be recoverable from the shareholders who received it.

The question of the liability of directors should be treated differently. That must depend on directorial behaviour in relation to the application of the solvency and liquidity test. Regarding the liquidity component, a twelve-month period, as introduced under the 2008 Act, is appropriate. In addition to the liquidity element, a solvency test bolsters the protection of creditors in this field. However, the liquidation preferences of preferred classes of shareholders should be included under the solvency component, as a default rule – the company's memorandum of incorporation can (explicitly) change this. I do not think it is absolutely necessary to provide for a margin over solvency.

It is clear that the information in correctly prepared accounts can be vital to the functioning of the solvency and liquidity test. Nevertheless, the validity of a distribution in the final analysis should turn on the actual solvency and liquidity of the company when the distribution is made. It should not be possible for directors to escape liability where they know that the company has suffered a loss since the time stated in the financial statements.⁴²⁶ The test must be capable of greater subtlety and accuracy.

The timing of the application of the solvency and liquidity test is something which has also been extensively analysed. The test should be satisfied at the time when payment occurs. A

⁴²⁵ The additional limitations of liability I discussed in chapter 5 are exactly that: limitations on *directorial liability*. They do not go to validity or legality.

⁴²⁶ Van der Linde *Aspects* 534.

distribution may not be made unless it appears the company will meet the solvency and liquidity test immediately after completing the proposed distribution. When the company intends to “make” a “proposed” distribution, a resolution acknowledging the board’s satisfaction that the company will meet the test must be adopted. The 120 day rule should only be relevant for the acknowledgment resolution: the actual enforceability of the distribution should not depend on it.⁴²⁷ And there should be a prohibition to the effect that a company is not allowed to carry out a distribution where the directors are no longer satisfied that the financial limitations are met.

(1) A company satisfies the solvency and liquidity test if -

(a) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued; and

(b) considering all reasonably foreseeable financial circumstances of the company at that time, it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months after the date on which the distribution has been carried out.

(2) Unless the memorandum of incorporation of the company provides otherwise, any amount that would be required to satisfy the preferential rights upon liquidation of shareholders whose preferential rights upon liquidation are superior to the rights upon liquidation of those receiving the distribution, should the company be liquidated at the time of the distribution, must be regarded as liabilities.

A measure of flexibility and leeway is afforded in the broad concept of “reasonably foreseeable financial circumstances”. It is probably formalistic to try exhaustively to pin down the numerous means by which the company’s financial position can legitimately be determined.

Liability for Distributions in Contravention of the Solvency and Liquidity Test⁴²⁸

⁴²⁷ 535.

⁴²⁸ See chapter 5 above.

Directors have to be held accountable for illegal distributions; corporate law also has to cater for the recovery of amounts from shareholders which they received in contravention of the financial limitations. Both of these topics should be expressly regulated. The 2008 Act only explicitly deals with directorial liability. Moreover, that topic is rather disparately regulated.⁴²⁹ Many of the problems with distributions encountered in the 2008 Act are endemic, and a lot of these problems carry over into issues surrounding liability. It will likely be desirable, not only to link directorial liability to insolvency and illiquidity in fact, but also to the failure to act reasonably or with due diligence in assessing the financial situation of the company. The 2008 Act limits liability to participation at the time of authorisation. Rather, liability should lie for implementing a distribution in contravention of the solvency and liquidity test. The scope of directorial liability must be determined by the contribution of co-directors and the recovery from shareholders. It may well be desirable to afford a director a direct right of recourse against shareholders where the director has already made good his liability to the company.⁴³⁰ Should the company afterwards recover the amount from a shareholder, that director will have to be reimbursed.⁴³¹ Shareholders should be liable with respect to any distribution they receive in contravention of the solvency and liquidity test – regardless of their knowledge of the violation or whether they acted in good faith. This constitutes a policy choice in favour of creditor protection.⁴³²

(1) A director of a company is liable to the company for the amount of any distribution that exceeds what could have been distributed without violating the solvency and liquidity test, to the extent that that amount has not been recovered from shareholders, if that director –

(a) was present at the meeting and failed to vote against the adoption of a resolution in which the board acknowledged that it has applied the solvency and liquidity test and reasonably concluded that the company will satisfy the solvency and liquidity test, and it was unreasonable to reach that conclusion; or

⁴²⁹ The Act again forces one to jump around quite a bit: you will need to consult at least section 46, section 77(3)(e)(vi), and section 77(4).

⁴³⁰ Van der Linde *Aspects* 545.

⁴³¹ 545.

⁴³² The company, and ultimately the creditors, will more often than not be the big loser, if this were not so. Should a sizeable group of shareholders who receive an illegal distribution in good faith be allowed to keep it, the potential liability of a small group of directors will be exorbitant. The probability of the company achieving a full recovery will be low. And creditors will in the final analysis bear the brunt of a radical reduction in company value.

*(b) had knowledge that the company would imminently make, or proceed with, a distribution in circumstances where it was unreasonable to have remained satisfied of the company's solvency and liquidity, and failed to take reasonable steps to stop the making of the distribution.*⁴³³

(2) A shareholder or former shareholder who received a distribution made in contravention of the solvency and liquidity test is liable to the company for the amount of the distribution.

(3) A director who incurs liability in terms of this section is jointly and severally liable with any other directors who are so liable.

*(4) A director who incurs liability in terms of this section may institute a claim against a shareholder to recover the amount of the distribution on behalf of the company, or to the extent that the director has already restored the amount to the company, on behalf of that director personally.*⁴³⁴

It remains to tie things up in the final chapter, in which I will draw some general conclusions resulting from the study. As I have already provided conclusions to all the themes I covered in each respective chapter, it will not be necessary to do so again at any great length. Accordingly, the final chapter takes a more philosophical meta-perspective, and reflects, amongst other things, on the nature of this study.

⁴³³ 570.

⁴³⁴ 570.

Chapter 7

Concluding Remarks

I have argued that linguistic communication comprises a rich and complex process in which semantics and pragmatic (contextual) elements interact – the full content of an utterance, what is ultimately asserted, is necessarily the result, not just of intention or meaning, but something richer in which these two elements, loosely speaking, interact, together with relevant contextual features.⁴³⁵ Accurately tracing this process is difficult in the case of a simple and clear conversation between two people. In an institutional setting, involving many varied actors, the process is even more complex. But I have also shown that it is not impossible.⁴³⁶

In the case of a relatively unitary, sensible legislature, with more or less clear policy goals, and competent expressive capacities, hard cases cannot be eliminated, but the law would be clear for the most part. This model breaks down to some extent when one is dealing with a legislature that lacks a coherent policy agenda for the particular legislation and poorly expresses its purported aims. It is doubtful whether the legislature has succeeded in drafting laws that reflect its aims. Moreover, the underlying philosophy or broad aims, at many junctures, seems to be difficult to establish.

I have attempted to evaluate the discernible (underlying) aims and their implementation in the 2008 Act, in this thesis. It has emerged that various parts of the statutory provisions on distributions seem to be unworkable. At times the objectives have not been shrewdly devised; at other times the wording has been poorly drafted. I have tried to point out where in the law on distributions this is the case. I have attempted to show where taking interpretative liberties will suffice; and where it will not. Reforms will no doubt be necessary for the areas in which the Act is simply incomprehensible in practice.⁴³⁷

In order to gauge legal content, it is the (legal) assertion which must be understood.⁴³⁸ And pragmatic (contextual) features normally play a role here. It has been difficult to identify concrete contenders that could play this role when it comes to corporate finance law in

⁴³⁵ Particularly see the diagram on page 35; and more generally the whole of chapter 2.

⁴³⁶ See chapter 2.

⁴³⁷ See chapter 6.

⁴³⁸ See 2.3 above.

general and the law on distributions in particular; an ad hoc approach to this issue was thus most congenial. It has been concluded that the purposes of section 7 of the 2008 Act cannot really play a significant role in this regard.⁴³⁹ An analysis of the case law has confirmed this. The rhetoric of the courts often suggests that the section 7 purposes are instrumental in deciding corporate law cases, but in truth their role is tangential at best. The purposes prove cosmetic, as the ultimate decision is always reached on different, concrete grounds. That is to say, the purpose(s) never play(s) a truly substantive or constitutive role in the court's reasoning.⁴⁴⁰ And this is entirely predictable, given the vagueness of the purposes. It was found that, rather than having recourse to vague purposes, viewing the distribution provisions in the light of the dynamics of solvency and liquidity proved more fruitful.

The question of the linguistic or communicative limits to creative interpretation, in cases where the language of the relevant provisions of the Act is highly problematic, has tentatively been answered at the various points in this thesis, where I face up to the interpretative problems the Act produces. The concomitant question of the authoritative or legitimacy limits to acts of creative interpretation is perhaps more difficult.

In the epistemic task of ascertaining the content of the law, this question is not so pertinent: it is the constitutive aspect, in which authoritative judgments co-determine the content of the law, which poses the problem. I have been cautious throughout this study in making these constitutive judgments. My view is that authoritative law-makers are essentially entrusted with this task. In other words, legislatures and judges have the authority to do this.

A legal scholar can advance a constitutive judgment about the law and be very persuasive about it; legal philosophy, linguistic philosophy, social theory, economic theory, logic and good sense could certainly dictate a cogent judgment of this nature which, in effect, changes the law. But the legitimacy of such a judgment is in doubt – it is only really when a judge accepts such a constitutive interpretation that it carries legal sway. For this reason, I have not been too ambitious in my interpretative proposals. I have mostly seen fit to suggest legislative amendments (especially in the areas where the law seems almost unworkable). The extent to which this has been found to be necessary under the law on distributions has been rather striking.

⁴³⁹ See especially 3.3 above.

⁴⁴⁰ In particular see 3.3 above.

It has also been seen that a rigorous linguistic philosophy framework is able to assist in theorising about difficult interpretative problems. Just as the assertive content of an ordinary conversation cannot generally be identified with the (semantic) *meanings* of the sentences used (or with the aims of the conversationalists in saying what they do), so the assertive content of a legal text (such as the 2008 Act) cannot generally be identified with the meanings of the sentences making up the provisions (or with the policy aims motivating lawmakers to adopt it).⁴⁴¹ In the same vein, the content of the 2008 Act cannot without more be identified with any normative improvement of what the lawmakers (actually) asserted.⁴⁴²

Under the framework which I employed, I have pointed out how certain provisions can best be interpreted. But the most significant result is that, given the disjointed nature of the policy goals and the unclear mode of expression, substantial reforms will be necessary.⁴⁴³ I have tried to show, under the Soames model of interpretation that I employ, the limits of the interpretative task. Where normative improvements appear materially necessary, the interpretative task flirts precariously with daunting fundamental questions of authority and legitimacy.

The most fundamental requirement for distributions is the solvency and liquidity requirement. It was found that the 2008 Act's move from a capital maintenance system to a solvency and liquidity regime has merit.⁴⁴⁴ An economic analysis was performed to look into this requirement and the underlying question of creditor protection.⁴⁴⁵ The general logic of the solvency and liquidity approach was found to be sound, as the principle constitutes an appropriate mechanism to protect creditors, *inter alia*, in the making of distributions.

It is the more detailed mechanics, and the overall coherence of the place of solvency and liquidity in the law on distributions which leaves much to be desired. In particular the relationship between the authorisation of a distribution and the acknowledgment of solvency and liquidity is unsatisfactory.⁴⁴⁶ And it was shown how conceptual errors such as this carry

⁴⁴¹ See 2.2 above.

⁴⁴² See 2.2 and 2.3 above.

⁴⁴³ See chapter 6.

⁴⁴⁴ See 1.2.1 above.

⁴⁴⁵ See 1.2.2 above.

⁴⁴⁶ See 4.2 above.

over into other crucial areas, such as directorial liability.⁴⁴⁷ This is, for instance, an area in which substantive legislative revision is recommended.

Recapitulating the conclusions of the preceding chapters more specifically, in chapter 2 I explained my approach to legal interpretation. I supplied the necessary conceptual tools and distinctions and provided examples of how legal interpretation should be understood (and how it should not be understood). This chapter installed a framework for the interpretative and legislative suggestions that followed throughout the thesis. It was found that (legal) pragmatic tools to aid interpretation are difficult to come by; and it was suggested that ambitious interpretative proposals must proceed by using principled criteria and cannot remain unsubstantiated. It was concluded that interpretative moves that do not follow self-evidently from legal content have to be justified. The suggested framework is a general interpretative mode, derived from the nature of communication itself and so could – I would urge, *should* – be employed in relation to any piece of legislation or other legal text.⁴⁴⁸

Chapter 3 was devoted to an analysis of the solvency and liquidity requirement, which forms a base requirement of the law on distributions under the new company law system. The chapter showed that the solvency and liquidity test constitutes an appropriate limitation on distributions to shareholders. The more specific mechanics of its operation, as prescribed by the 2008 Act, however, were found to be unsatisfactory. It was concluded that substantive revision will be crucial in this area. The conclusion was reached that the purposes of section 7 do not play a role in the interpretation of solvency and liquidity. I suggested that it would be more beneficial to interpret the distribution provisions in view of the concept of solvency and liquidity.

Chapter 4 was an attempt to disentangle and clarify the opaque relationship between the authorisation of a distribution and the acknowledgment of solvency and liquidity. It was clear that this relationship has not been coherently conceived. I noted the interdependence between the requirement of solvency and liquidity on the one hand, and the authorisation of the distribution and the acknowledgment of solvency and liquidity on the other.

⁴⁴⁷ See chapter 5.

⁴⁴⁸ See especially 2.3.

Chapter 5 dealt with the question of liability for unlawful distributions. It was concluded that the problems elucidated in the preceding chapter have a knock-on effect on the question of liability for unlawful distributions. The interdependence and interplay between solvency and liquidity, the requirements for distributions, and the liability of directors was established. It was suggested that efficiency, good sense, and coherence on rare occasions require normative improvements to the text of the 2008 Act.

Chapter 6 briefly sets out some recommended provisions that could remedy the defects highlighted in the previous chapters. This comprised the essentially prescriptive chapter where positive reforms proposals were advanced. In addition to piecemeal interpretative suggestions on the back of the Soames interpretation theory, therefore, I have also adduced draft proposals for reform, in order to suggest more fruitful and coherent approaches to future regulation on the issue. The provisions I recommend are not meant to be adopted verbatim; but they can serve as a springboard for future reform in this area.⁴⁴⁹

⁴⁴⁹ As I have said, the numbering and cross-referencing issue makes this impossible, lest a whole new Act is introduced (and I do not see this happening in the near future). At best, then, the provisions can serve as a template for future reform.

Chapter 8

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